



E THE ARIZONA CORPORATION COMMISSION

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CHAIRMAN
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5

6 IN THE MATTER OF THE APPLICATION OF)
U S WEST COMMUNICATIONS, INC. A)
7 COLORADO CORPORATION, FOR A HEARING)
TO DETERMINE THE EARNINGS OF THE)
8 COMPANY, THE FAIR VALUE OF THE)
COMPANY FOR RATEMAKING PURPOSES,)
9 TO FIX A JUST AND REASONABLE RATE OF)
RETURN THEREON AND TO APPROVE RATE)
10 SCHEDULES DESIGNED TO DEVELOP SUCH)
RETURN.)
11

DOCKET NO. T-01051B-99-0105

STAFF'S NOTICE OF FILING
SURREBUTTAL TESTIMONY

12 The Arizona Corporation Commission Staff ("Staff") hereby files the redacted
13 Surrebuttal Testimony of Michael C. Brosch, Steven C. Carver, Stephen G. Hill, William Dunkel,
14 and Harry M. Shooshan III. Unredacted copies of Mr. Carver's and Mr. Dunkel's testimony are
15 being provided in a separate, sealed envelope to the Hearing Officer, Applicant U S WEST
16 Communications, Inc., now known as Qwest Corporation, and parties that have executed a protective
17 agreement in this docket.

18 RESPECTFULLY SUBMITTED this 8th day of September, 2000.
19

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1 Original and fifteen copies of the foregoing
2 "Notice of Filing" and "Redacted Surrebuttal
3 Testimony" were filed this 8th day of
4 September, 2000, with:

5 Docket Control
6 Arizona Corporation Commission
7 1200 West Washington Street
8 Phoenix, Arizona 85007

9 Copies of the foregoing "Notice of Filing"
10 and "Redacted Surrebuttal Testimony" were
11 were mailed this 8th day of September, 2000 to:

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**TABLE OF CONTENTS
SURREBUTTAL TESTIMONY OF
MICHAEL L. BROSCH**

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<u>Issue Area</u>	<u>Testimony Page</u>	<u>Schedule</u>
Executive Summary	2	
Revenue Adjustments	5	C-1, 2, 3, 4, 6
Service Quality Penalties	7	C-8
Directory Imputation	9	C-5
Employee Concession Services	18	C-21
Cash Working Capital	20	B-4
Plant Records Adjustment	23	B-1, C-22
Sale of Exchanges	26	C-29
Reciprocal Compensation	27	C-30
U S West Inc. Disallowances	29	C-20

**BEFORE THE
ARIZONA CORPORATION COMMISSION
SURREBUTTAL TESTIMONY OF
MICHAEL L. BROSCH**

1 Q. Please state your name and business address.

2 A. My name is Michael L. Brosch. My business address is 740 North Blue Parkway, Suite 204,
3 Lee's Summit, Missouri 64086.

4 Q. Are you the same Michael L. Brosch who previously submitted prepared Direct Testimony in
5 this Docket?

6 A. Yes. My qualifications and work experience were provided in my Direct Testimony.

7 Q. What is the purpose of your Surrebuttal Testimony in this Docket?

8 A. My testimony is responsive to the rebuttal testimonies and related exhibits of Company
9 witnesses Mr. George Redding, Ms. Ann Koehler-Christensen and Mr. Kerry Dennis Wu. The
10 index prepared for this testimony lists the topics addressed herein, in the same sequence the
11 issues appeared in my earlier Direct Testimony. Where an issue and adjustment was contained
12 in my index for the earlier Direct Testimony that is not listed in the Surrebuttal index, the
13 Company has submitted no rebuttal on that subject.

EXECUTIVE SUMMARY

1 Q. Has the Company's rebuttal evidence caused you to revise any of the adjustments that are
2 addressed in your Direct Testimony?

3 A. No. In each of the areas where the Company's rebuttal was critical of my specific proposals,
4 I see no need to make revisions to the adjustments in Staff's direct filing based upon review
5 of such rebuttal. In several areas addressed in my Direct Testimony, including revenue
6 annualization, uncollectibles, rent compensation, affiliate true-up transactions, public policy
7 costs, fair value and the treatment of broadband services, the Company's rebuttal either accepts
8 the adjustment I propose or is not critical of my adjustments. There is, however, one change
9 to Staff Accounting Schedule / Adjustment C-30 dealing with reciprocal compensation. This
10 change is due to corrections made by USWC to its response Data Request 62-18 that was
11 relied upon to quantify Staff's initial adjustment.

12 Q. Please summarize the status of Staff's revenue adjustments other than directory imputation that
13 you sponsor?

14 A. In Mr. Redding's rebuttal, a graph is presented that seems to indicate that the Company
15 believes Staff's adjustments to normalize and annualize revenues at year-end (Staff Schedules
16 C-1, 2, 3 and 4) produce an overall result that is reasonable. At page 16 of his rebuttal, Mr.
17 Redding states, "As to Revenues, Rebuttal Exhibit GAR-R1 shows that Qwest, Staff and
18 RUCO are all very close with the exception of directory imputation". This statement, and the
19 absence of any rebuttal to Staff's revenue annualization schedules, suggests that the Company
20 does not dispute the referenced adjustments.

21 Q. Please summarize the status of the dispute regarding costs associated with the Arizona service
22 quality program.

23 A. Mr. Redding argues that such costs should be included in revenue requirements as part of the
24 ongoing normal cost of doing business, particularly since the Company is the supplier of last

1 resort. Staff continues to oppose rate case recovery of service quality program costs from the
2 general body of ratepayers as contrary to the intent of the program, a disincentive to
3 management to improve service quality, and fundamentally unfair to ratepayers. These costs
4 represent penalties and remedies for inadequate service that should not simply re-allocated to
5 other customers within rate cases. Treating such costs as routine costs of doing business
6 removes the incentive to the Company to improve service quality.

7 Q. Please summarize the directory imputation issue remaining between Staff and USWC that is
8 addressed in your Surrebuttal Testimony.

9 A. Staff has imputed directory revenues based upon the Settlement Agreement \$43 million level
10 that was previously agreed upon between the Company and Staff and approved by the
11 Commission, rejecting the Company's position that imputation should cease. My Surrebuttal
12 explains why Ms. Koehler-Christensen is incorrect in concluding that Staff has not fully
13 complied with the directory Settlement Agreement. I note the many infirmities in her
14 assumptions and conclusions with respect to the sources and amounts of "value of services".

15 Q. Should the costs of employee benefits in the form of telephone service concessions be fully
16 charged to intrastate customers, as indicated by Mr. Redding?

17 A. No. Staff Schedule C-21 allocated a portion of employee telephone service concessions to the
18 interstate jurisdiction, so as to recognize that Company employees work for the benefit of both
19 interstate and intrastate customers and the cost of these benefits should be equitably allocated
20 across jurisdictions, in the same manner wages and other benefits are allocated. Mr. Redding's
21 rebuttal suggests that such an allocation is effectively a disallowance of such costs. In
22 Surrebuttal, I explain that there is no such disallowance, because the Company's interstate rates
23 are not subject to cost-based regulation where the concept of disallowance has any meaning.

24 Q. What is the status of differences in the calculation of cash working capital in rate base?

1 A. Staff's filing includes several revisions to lag day values associated with the payment of
2 employee compensation and benefits, interest expense, payroll taxes and miscellaneous cash
3 vouchers. The Company's rebuttal states no specific criticism of these adjustments, but instead
4 indicates USWC was unable to replicate Staff's lag day results.. Workpapers have been
5 provided to fully document Staff's adjustments and they remain appropriate for the reasons
6 stated in my Direct Testimony. Most of the cash working capital difference between Staff and
7 USWC relates to a \$7 million error in USWC's filing, as conceded in Mr. Redding's rebuttal.

8 Q. Please summarize your Surrebuttal regarding the unrecorded plant asset retirements and
9 corresponding depreciation expense effects that are quantified in Staff's Schedule C-22.

10 A. Staff has proposed no rate base adjustment for unrecorded retirements, contrary to Mr. Wu's
11 rebuttal. The Company offers no evidence that the old vintages of plant challenged by Staff
12 has been investigated to determine if it remains in service and subject to ongoing depreciation
13 expense. No recalculation of depreciation accrual rates is required due to Staff's adjustment.

14 Q. What remains at issue with regard to the detailed calculations and allocations of costs to the
15 Arizona exchanges being sold by USWC to Citizens?

16 A. Mr. Redding disputes my adjustment to include reasonable allocations of marketing and
17 corporate operations expenses to the exchanges being sold. My Surrebuttal explains the
18 rationale for Staff's allocations and the reasons why such costs are not completely fixed in
19 nature, as suggested by USWC.

20 Q. Please summarize your Surrebuttal regarding reciprocal compensation costs and ratemaking?

21 A. I explain that reciprocal compensation is best treated as part of the Company's total revenue
22 requirement, and does not merit the extraordinary rate rider treatment advocated by USWC.
23 There is no evidence that reciprocal compensation is now, or in the future will ever be, large
24 enough or volatile enough to warrant special rate tracking with all the associated costs, risks
25 and complexity such rate tracking may involve for ratepayers.

REVENUE ADJUSTMENTS

1 Q. How did Mr. Redding respond in rebuttal to the Staff adjustments to annualize local, access,
2 toll and miscellaneous revenues?

3 A. Mr. Redding has no rebuttal to the individual issues and adjustments set forth on Staff
4 Schedules C-1, C-2, C-3 and C-4 that correct and restate the Company's year-end revenue
5 annualization adjustments. Instead, an overall test of the reasonableness of Staff's revenue
6 result is presented in graph form in Mr. Redding's Exhibit GAR-R1. According to page 16 of
7 his rebuttal, "These charts clearly show that the Company's advocacy to bring all elements of
8 revenue and expense to end of period levels is more representative of future conditions than
9 either Staff's or RUCO's. As to Revenues, Rebuttal Exhibit GAR-R1 shows that Qwest, Staff
10 and RUCO are all very close with the exception of directory imputation, which was excluded
11 for this chart." Thus, it appears that Mr. Redding's analysis corroborates Staff's own analysis.

12 These four Staff revenue adjustments (C-1, C-2, C-3 and C-4) adhere to prior Commission-
13 ordered treatment of revenue annualization, based upon the types of revenues in each account,
14 as described in my Direct Testimony. In addition, two of these Staff adjustments correct errors
15 in the Company's filing that were acknowledged in discovery responses. Given the
16 reasonableness of Staff's overall result and the importance of correcting errors and maintaining
17 consistency with prior ratemaking policies established by the Commission, it is important that
18 these four adjustments be approved by the Commission.

19 Q. What is the Company's response to the Staff's proposed treatment of Broadband affiliate
20 revenues and expenses in Staff adjustment Schedule C-6?

21 A. At page 47 of his rebuttal, Mr. Redding states, "The Company has reviewed Staff's adjustment
22 to the affiliate billing estimates between Qwest and Broadband Services, Inc. (BSI), the
23 broadband affiliate. Given the start-up nature of BSI's operations, the Company does not

1 believe that Mr. Brosch's adjustments to the estimated billing between Qwest and BSI are
2 unreasonable."

3 Q. Are the additional revenues associated with Staff's Broadband Schedule C-6 adjustment also
4 included within Staff's total adjusted intrastate revenues shown to be reasonable in Mr.
5 Redding's Exhibit GAR-R1 graph?

6 A. Yes.

7 Q. In his rebuttal at page 47 on this issue, Mr. Redding also observes that Staff's Schedule B-6
8 rate base adjustment that reverses the Company's Broadband asset transfer is not objectionable,
9 "Pending clarification of the Company's intent with regard to the transfer of the assets...". Are
10 the Staff's proposed income statement adjustments contained in Schedule C-6 contingent upon
11 what happens with respect to the transfer of Broadband assets?

12 A. No. While the asset transfers may have some impact upon rental revenues to be realized by
13 USWC, the Staff's adjustment for ongoing affiliate transactions with BSI is conservative in
14 relation to actual transaction trends, as noted at page 81 of my Direct Testimony.

SERVICE QUALITY PENALTIES

1 Q. What is Mr. Redding's response to Staff' adjustment attributing service quality program costs
2 to shareholder rather than ratepayers?

3 A. According to page 40 of his rebuttal, "Qwest is the provider of last resort (POLR) for its
4 service territory in Arizona. As the POLR, it is obligated to serve every customer who wishes
5 to have service. This is an obligation not shared or borne by any other provider in Qwest's
6 operating territory in Arizona. Sometimes, the best way to provide service to a customer, when
7 traditional telephone facilities are not in place, is to provide alternative services during an
8 intervening period." Mr. Redding says the Company charges alternative service arrangements
9 to operating expenses because "they are a reasonable cost of doing business, and because
10 Qwest is indeed providing service the customer has requested."

11 Q. How do you respond to Mr Redding's "provider of last resort" claim?

12 A. Under the service quality program effective in Arizona, the Company is allowed an interval
13 of time to install service to customers and only when such installation does not occur within
14 the allowed time period are alternative service arrangement required. There has been no
15 showing by the Company that this Commission-approved installation interval is unreasonable
16 or that the benefits of incumbency realized by the Company in Arizona do not offset Mr.
17 Redding's claimed burden of being a provider of last resort. The "obligation" to serve all
18 customers might instead be viewed as a considerable market "opportunity" associated with the
19 incumbency advantage that is not possessed by the other providers. In addition, USWC has
20 not been authorized to substitute at its discretion cellular or other alternative service options
21 for the wireline telephone services the customer has requested.

22 Q. Are service program costs part of the Company's "reasonable cost of doing business" as Mr.
23 Redding asserts?

1 A. No. Revenue credits, service program penalties and the other interim service arrangements due
2 to service quality deficiencies imposed upon the Company were not intended to simply become
3 part of the normal cost of service. With respect to cellular and other forms of alternative
4 service, the Commission should not condone a policy of acceptance of failures to serve and the
5 widespread substitution of resold cellular services in place of wireline services. With a policy
6 of non-recovery of such costs, the Company faces an appropriate incentive to consistently
7 provide high-quality services within reasonable time periods. Adoption of the Company's
8 position of full recovery removes such incentives and introduces an attitude of indifference
9 with respect to serving individual customers that is not consistent with the public interest. I
10 encourage the Commission to find such costs a shareholder responsibility, consistent with the
11 policies applicable in Iowa and New Mexico that were described in my Direct Testimony.

DIRECTORY IMPUTATION

1 Q. According to Company witness Ms. Koehler-Christensen's rebuttal, "Staff and RUCO
2 consider the fees received by Qwest from DEX, but rather than determining the current value
3 of the services received, they rely on the \$43 million level from the original agreement." Did
4 you fail to fully consider the value of fees and services received by USWC as suggested by Ms.
5 Koehler-Christensen?

6 A. No. My Direct Testimony at pages 37 through 48 exhaustively analyzes the Company's novel
7 theories of value creation and allocation and addresses the value of fees and services received
8 by USWC from Dex. I conclude at page 48, "Using the amounts negotiated in the Settlement
9 Agreement as a starting point, the current value of the fees and services properly credited to
10 USWC in Arizona is no less than \$93.1 million, rather than only \$43 million." My testimony
11 also explains in considerable detail how this amount was derived and why the \$43 million
12 Settlement Agreement value must be viewed as an extremely conservative amount for
13 imputation purposes.

14 Q. At page 4 of her rebuttal, Ms. Koehler-Christensen states, "While Mr. Brosch claims the
15 current value is higher than I maintain, he provides no analysis or calculations to support his
16 claim. In fact, the only calculation he provides is based on the profits of DEX, a methodology
17 that the Arizona Appellate Court has squarely rejected." Is this correct?

18 A. No. The \$93.1 million value of services is completely documented in my workpapers and was
19 not based upon the profits of DEX, nor did it rely upon the method rejected by the Arizona
20 Appellate Court. In fact, the method that was rejected by the Court yields a \$104 million
21 imputation result, as noted at page 48, lines 13 through 17 of my Direct Testimony.

22 Q. Is your calculation of the \$93.1 million a "roundabout way of calculating directory imputation
23 using DEX's profits in excess of Qwest's authorized rate of return", as claimed by Ms.
24 Koehler-Christensen at page 5 of her rebuttal?

1 A. No. The \$93.1 million does not rely upon DEX net income or any determination of any
2 "authorized rate of return". As I noted in the prior response, the income-based calculation
3 produces an even higher \$104 million result that is entirely consistent with the ordered
4 imputation methodology in the Commission's last rate order, prior to reversal by the Court.

5 Q. Another claim made by Ms. Koehler-Christensen with respect to your testimony is that, "In
6 particular, he ignores the changes in the contractual relationship between the Company and
7 DEX, the legislative and regulatory changes that have reduced the value of the services
8 provided and the considerable changes that have occurred in both the publishing and the
9 telecommunications industries." Is this correct?

10 A. No. My testimony describes the unreasonable and imprudent changes effected in the affiliate
11 publishing agreements between USWC and US West Direct (later DEX) over the years. The
12 Settlement Agreement and history of imputation in Arizona and other states is ample evidence
13 of how "changes in the contractual relationship" between these corporate affiliates should not
14 be used to the disadvantage of ratepayers. As explained in my testimony, the Publishing
15 Agreement has been recognized by regulators to be a contrived arrangement between corporate
16 affiliates that is designed to convey to Dex the valuable benefits of affiliation with the
17 incumbent LEC for inadequate compensation.

18 With respect to the "legislative and regulatory changes" referred to by Ms. Koehler-
19 Christensen, there has been no showing of any negative impact upon the value USWC brings
20 to the affiliate publishing venture with DEX. In fact, the favorable trend in revenues and
21 profits of DEX indicates just the opposite, that the value of the affiliate publishing relationship
22 with USWC continues to increase. Today, just as in the past, advertisers who can afford to
23 advertise in only one yellow pages must advertise in the official Dex book to have confidence
24 that their advertisement reaches the broadest audience.

1 Q. At page 5 of her rebuttal, Ms. Koehler-Christensen asserts that "The Company has a contract
2 with DEX to assure that its regulatory obligations are met and that directories are published
3 and delivered to all Qwest's customers. This contract is the same as DEX has with over one
4 hundred CLECs and ILECs." Is this important?

5 A. No. The specific contractual terms of the affiliate Publishing Agreement between USWC and
6 DEX do not serve as the basis for imputation in Arizona. If the ACC had been able to rely
7 upon the Publishing Agreement to protect Arizona ratepayers, it would never have been
8 necessary to make imputation adjustments or negotiate Settlement Agreements to preserve a
9 directory revenue for ratemaking purposes.

10 While it seems important to Ms. Koehler-Christensen to make the point that on paper and
11 pursuant to affiliate contract, the DEX and USWC relationship is not unique, it is unrealistic
12 to conclude that DEX's symbiotic relationship with USWC is fully documented or fairly
13 compensated within the Publishing Agreement. In fact, my Direct Testimony at page 33
14 explains the many intangible benefits of affiliation with USWC that are realized only by DEX.
15 Furthermore, the Settlement Agreement that governs imputation in this case did not make
16 imputation contingent upon the affiliate publishing agreement or upon the offering of the same
17 publishing agreement services to non-affiliated telephone companies. In fact, the Settlement
18 Agreement at paragraph 3(c) specifically provides that changes in the terms of the affiliate
19 publishing contract will not control imputation:

20 Mountain Bell and the Commission agree that in subsequent rate cases
21 downward adjustments from the \$43 million in fees received by
22 Mountain Bell from USWD and included in Mountain Bell's 1984 rate
23 case will require more than a showing by Mountain Bell that it
24 negotiated a lesser amount with USWD.

25 The parties to the Settlement clearly recognized that corporate affiliates could not be trusted
26 to negotiate in good faith in a manner that preserves the ratepayers' financial interest in the
27 publishing business.

1 Q. At page 6 of her rebuttal, Ms. Koehler-Christensen criticizes you for not providing evidence
2 of the value of official publisher status under competitive bids. Is it Staff's obligation to solicit
3 bids or identify comparably transactions in order to honor the Settlement Agreement
4 imputation amount?

5 A. No. Staff has presented evidence that the value of services received by USWC from Dex is
6 considerably negative and that a much larger imputation than \$43 million would be reasonable
7 because of the value Dex realizes in jointly producing directories in cooperation with the
8 dominant incumbent LEC in Arizona. I agree with Ms. Koehler-Christensen that other
9 incumbent LEC's have not solicited bids for publishing services. This is undoubtedly because
10 they also sought to retain directory profits and minimize the regulatory recognition of the
11 lucrative directory publishing opportunity associated with being the incumbent telephone
12 company and directory publisher. U S West is not unique in its efforts to retain for
13 shareholders the maximum level of directory profits that will be tolerated by regulators.

14 Q. At page 7 of her rebuttal, Ms. Koehler-Christensen states, "No publisher has ever approached
15 the Company and the Company has no reason to believe that another publisher would offer the
16 Company an arrangement that would be more favorable than the current publishing agreement
17 with DEX." Does this statement indicate anything about the value of fees and services in the
18 Dex/USWC relationship?

19 A. No. There has never been any serious solicitation by U S West seeking competitive publishing
20 services for the incumbent directory business in USWC's territory. There is no basis for
21 competing publishers to assume that U S West would ever seriously consider outside suppliers
22 to displace Dex's core business relationship with USWC. Instead, Dex's services have
23 consistently been contracted without any exposure to competitive bidding or any other "test"
24 of the non-arm's length affiliate contract terms that were made effective. There is simply no
25 reason for another publisher to assume USWC ever intended to terminate its contract with the
26 Dex affiliate for exclusive official publishing services and allow a non-affiliated third party to
27 become involved in the lucrative business of publishing U S West in-region directories.

1 Q. Ms. Koehler-Christensen also criticizes you for providing “no evidence” to support your
2 assertion that “the Company could contract with another publisher and ‘at an absolute
3 minimum receive publishing and distribution at no cost in return for the granting of official
4 publisher status.” How do you respond?

5 A. Some claims are self-evident. The clearest evidence on this point is the existing Publishing
6 Agreement between USWC and Dex, which provides publishing and distribution services to
7 USWC at no cost. Dex provides such services at no cost to USWC because this is, in my
8 opinion, the minimum reasonable compensation that maintains any credibility before
9 regulators. If Dex tried to actually charge USWC for manufacturing the white pages and
10 delivering the directories, while simultaneously retaining for itself all yellow pages and white
11 pages advertising revenues, the Publishing Agreement would be utterly indefensible. In its
12 present form, the Publishing Agreement allows Ms. Koehler-Christensen the opportunity to
13 argue that USWC gets the same publishing “deal” as other non-affiliated telephone companies
14 receive from Dex – even though such argument ignores the considerable value associated with
15 Dex’ use of the intangible assets of USWC without compensation.

16 Additional proof that telephone companies would, at a minimum, receive “free” publication
17 of white and yellow pages directories in return for “official” publishing status can be observed
18 in the Dex contracts with non-affiliated telephone companies. Dex does not charge other
19 telephone companies for publishing their white and yellow pages listings. However, Ms.
20 Koehler-Christensen’s theory of value is that Dex could or should charge USWC for the costs
21 of such publishing services. It appears that this theory was created for the sake of regulatory
22 argument, since it is completely inconsistent with Dex’s publishing agreements with USWC
23 and with independent and competitive LEC’s.

24 Q. At pages 8 and 9 of her rebuttal, Ms. Koehler-Christensen challenges your claims with respect
25 to the unique benefits Dex receives from its affiliation with USWC. Has she indicated any
26 factual errors in your Direct Testimony with regard to these points?

1 A. No. She suggests that Dex's use of common trade names and marks with USWC is simply a
2 coincidence of having the same corporate owner and has nothing to do with any public
3 perception that Dex seeks to achieve that its directories are the sole official book. The
4 Washington Utilities and Transportation Commission recently ruled that this view was not
5 credible:

6 We find no indication that the logo of U S WEST Communications,
7 Inc., connotes in the popular view an entirely different company from
8 that connoted by any other U S WEST corporate family logo [footnote
9 omitted]. We find it not credible that consumers see the U S WEST
10 Communications logo, with its stylized U S WEST lettering, see the
11 identical U S WEST lettering with the name "Dex," and view them as
12 totally distinct and unrelated companies as opposed to related products
13 under a single umbrella. In any event, the substitution of the U S
14 WEST logo for that of PNB was a choice made by U S WEST, Inc. and
15 PNB and should not be used to justify the evaporation of any
16 publishing rights or financial benefits previously held by PNB.¹

17 Ms. Koehler-Christensen also does not challenge the fact that Dex and only Dex has its
18 advertising charges included within USWC's telephone service billings. Dex is the only
19 publisher allowed to sell its receivables to USWC, share corporate management with USWC
20 and receive referrals for advertising from USWC, the primary incumbent LEC in Arizona. It
21 is, in my opinion, beyond dispute that Dex leverages its affiliation with USWC to profitable
22 advantage in dominating the published directory markets in its service territory.

23 Q. At page 9 of her rebuttal, Ms. Koehler-Christensen states that Dex does not inappropriately
24 earn and retain revenues from selling white page advertising. Why does it matter in this
25 Docket that Dex earns advertising revenues from white pages?

26 A. It matters because an important claim in Ms. Koehler-Christensen's Direct Testimony was that
27 USWC receives a large "value" from Dex in avoiding incurrence of the cost of manufacturing

¹ WUTC Fourteenth Supplemental Order; Order Denying Petition in Docket No. UT-980948 at page 39 (July 2000) "PNB" stands for Pacific Northwest Bell, one of the three pre-divestiture Bell operating companies that became USWC.

1 and delivering white pages. If Dex earns white pages "advertising" income that offsets its
2 incurred costs of manufacturing and delivering the white pages, USWC should also be
3 assumed to have the ability to earn such offsetting revenues. However, in her value
4 quantification, Ms. Koehler-Christensen addresses only the costs of white pages and ignores
5 the advertising therein. She improperly relies upon distant history in her rebuttal stating,
6 "When the directory operations were part of Mountain Bell, the Company did not sell
7 advertising in the white pages." My point is that if Ms. Koehler-Christensen wants us to
8 assume (contrary to the Publishing Agreement) that USWC has cost responsibility for
9 producing the white pages today, we should not ignore the fact that white pages produce
10 offsetting advertising revenues today. Her assumptions regarding value of services to USWC
11 have the effect of making USWC a publisher of white pages in terms of cost responsibility, yet
12 Ms. Koehler-Christensen argues that "Publishers, not LECs, sell white pages advertising" and
13 she improperly ignores these offsetting revenues in her analysis.

14 Q. At page 10 of her rebuttal, Ms. Koehler-Christensen says it is "not reasonable" to expect that
15 USWC could easily reenter the publishing business and earn a net profit. Would it be
16 necessary for the Company to hire employees and develop publishing systems in order to
17 reenter the publishing business?

18 A. Not necessarily. It is entirely possible for USWC to reenter the business by contracting with
19 an existing publisher that already has the personnel and systems required to publish profitable
20 directories. However, the larger problem with USWC reentry, as noted in my Direct
21 Testimony, would be the need to eliminate obstruction in such a reentry strategy that could be
22 mounted by Dex and the common parent company. All of the challenges of reentry that are
23 noted by Ms. Koehler-Christensen originated with the uncompensated transfer of directory
24 publishing assets, personnel and customer relationships at divestiture and the subsequent
25 publishing agreements that have been found to be unreasonable by the ACC and other
26 Commissions. For example, the aforementioned Washington Utilities and Transportation

1 Commission Order earlier this year found as follows with respect to the initial transfer of
2 directory publishing to U S West Direct ("USWD"):

3 160 U S WEST states that it always provided full disclosure about the
4 transaction *U S WEST Brief*, p.33. In light of the record and USWC's
5 earlier positions, this statement is difficult to understand. If it intended
6 a transfer of the entire business, not only did it not tell the Commission
7 it was transferring the entire business (nor the value of the ongoing
8 business ostensibly transferred), its application stated that it was
9 arranging for publication, and it subsequently represented through the
10 sworn statements of witnesses (Ms. Koehler-Christianson and Mr.
11 Johnson) and legal positions [footnotes omitted] that no transfer of
12 intangible assets occurred. Mr. Inouye states at transcript pages 263-
13 264 and Ms. Koehler-Christianson acknowledges at transcript page
14 1001 that the changes in their statements are the result of the
15 Company's desire to support the existence of a completed, permanent
16 transfer that the Company contends is demanded by its interpretation
17 of the Court's decision.

18 161 U S WEST's statements now about the facts and the meaning of its own
19 actions are so clearly contrary to the events and representations at the
20 time that they cast serious doubt on the credibility of the Company's
21 case. If we are to believe that it did in fact transfer all rights to the
22 business, it never once told the Commission that it was effecting the
23 complete and total transfer of an immensely valuable asset, contrary to
24 its obligation under law to seek approval for such a transaction. The
25 Company failed to maintain the documentation ordered by the
26 Commission that is essential to the valuation of the asset that it now
27 seeks us to make. Again and again, the contemporaneous information
28 that PNB and USWC provided and its arguments are inconsistent with
29 the facts and the positions that USWC now espouses.²

30 As I noted in my Direct Testimony at page 39, it would be quite possible for USWC to reenter
31 the directory publishing business if the common parent company of USWC and Dex desired
32 such reintegration of publishing with telephony. Transferring employees, automated systems,
33 physical assets and customer relationships back into the telephone company could position

² Ibid, page 42.

1 USWC to realize all of the costs and revenues of directory publishing in Arizona, rather than
2 only \$43 million in imputation.

3 Q. According to page 11 of Ms. Koehler-Christensen's rebuttal, the value of official publisher
4 status has decreased over the years. Do you agree?

5 A. No. The value realized by Dex in serving as official publisher for USWC continues to
6 increase. This is amply demonstrated by the strongly favorable trends in revenues, gross
7 margins and income realized by Dex. The only structural advantage Dex has relative to other
8 competitive independent publishers is its relationship with USWC and beneficial access to
9 intangible assets of USWC that convey value to Dex. If not for these benefits, competition in
10 directory publishing would serve to reduce the realized returns of Dex toward the cost of
11 capital. In my view, the value of the official publisher status conveyed to Dex has increased
12 since the Settlement Agreement was approved by the Commission.

EMPLOYEE CONCESSION SERVICE

1 Q. At page 49 of his rebuttal, Mr. Redding claims that your employee concession adjustment
2 allocating part of this employee benefit cost to the interstate jurisdiction is "entirely
3 unnecessary and inappropriate". As his first point in this regard, he claims, "This is
4 inappropriate because USWC can only discount its intrastate intraLATA services to its
5 employees and retirees." How do you respond?

6 A. What is being discounted, intrastate versus interstate, should not matter. The reality is that an
7 employee benefit is being provided to employees that serve both jurisdictions and all other
8 costs of such employment, including wages, health insurance, pensions, payroll taxes and
9 compensated absences are allocated between the intrastate and interstate jurisdictions. Equity
10 demands a similar allocation for the employee concession employee benefit. Even Mr.
11 Redding admits at page 50 of his rebuttal that Staff's consistency argument is "superficially
12 plausible". In truth, it is absolutely necessary to make this adjustment to avoid the
13 unreasonable outcome on the books where all concession costs are charged entirely to the
14 intrastate jurisdiction solely because the services being discounted happen to be intrastate
15 services. If equivalent compensation value was given employees in any other form, the
16 incurred costs would be subject to allocation across both jurisdictions.

17 Q. How do you respond to Mr. Redding's other argument for rejection of your allocation of
18 employee concessions?

19 A. Mr. Redding suggests that allocating these employee benefits is unfair to the Company because
20 of the inability to recover such costs from interstate customers. He claims at page 50:

21 ...that assignment of a portion of these costs to the interstate jurisdiction
22 is a disallowance of these costs more akin to a penalty. QWEST can
23 recover none of the cost of Mr. Brosch's imputation of revenues to the
24 interstate jurisdiction because the separations procedures do not allow
25 any portion of the revenue upon which the discount is given to be
26 allocated to the interstate jurisdiction. Consequently, Mr. Brosch is
27 really proposing to penalize the Company by disallowing recovery of

1 a perfectly legitimate, long-standing and long-accepted employee
2 benefit.

3 However, there is no substance to this argument. The Company's rates to interstate customers
4 are not based upon traditional regulation and periodic test period allocations of cost of service.
5 Therefore, even if the allocation problem Mr. Redding theorizes did not exist, there would be
6 no opportunity to explicitly increase interstate rates to recover such costs.³

7 Q. Even if interstate rates were not price-capped, should Mr. Redding's asserted inability to
8 recover allocated employee concessions from the interstate jurisdiction force the Arizona
9 Commission to include excessive costs in determining intrastate revenue requirements?

10 A. Not in my opinion. The Commission has historically adopted a policy of allowing rate case
11 recovery of employee concessions, but disallowing concession services provided to retirees.
12 In the absence of an equitable jurisdictional allocation of employee concession costs, the
13 Commission should reconsider its policy and explicitly disallow a portion of such costs as
14 excessive when attributed entirely to the intrastate jurisdiction.

³ This statement was confirmed by Mr. Redding in response to UTI 69-25.

CASH WORKING CAPITAL

1 Q. Does the Company agree with Staff's adjustments to cash working capital?

2 A. Mr. Redding's rebuttal at page 42 acknowledges that most of the difference in cash working
3 capital between Staff and the Company is associated with an error in the Company's filing.
4 With regard to the other lag day adjustments, Mr. Redding claims to be "unable to replicate"
5 the changes made by Staff. In addition, Mr. Redding asserts that two problems exist in the
6 lag day adjustments made by Staff.

7 Q. Did Staff provide the Company with workpapers supportive of its lag day adjustments?

8 A. Yes.

9 Q. Is Mr. Redding correct in his statement at page 43 that your lag day adjustment for
10 compensated absence timing "is unnecessary since this was already done on worksheet 24 of
11 the basic study"?

12 A. Not entirely. It is true that both the Company and Staff assign a revenue to this non-cash
13 expense. The adjustment in this area deals solely with the fact that the revenue lag used in the
14 Company's worksheet 24 was 23.0 days, while Staff's is 22.7 to match the composite revenue
15 lag on Schedule B-4. The financial effect of this change is revealed in Staff's workpapers to
16 be relatively inconsequential. The more significant adjustment made to the wage lag involves
17 Staff's incentive compensation adjustment.

18 Q. Do you agree with Mr. Redding on page 43 of rebuttal that part of the "Average Benefit
19 Liability" that you removed relates to the "liability for the savings plan" that needs to be
20 retained?

21 A. Yes. However, in response to Data Request UTI 69-23, the Company provided this amount
22 and it would reduce rate base by \$75,755 if included in Staff's calculations. The revenue

1 requirement effect of this change is only about \$10,000 and did not cause the Staff to
2 recalculate the lead lag study.

3 Q. Mr. Redding claims that your 0.6 day reduction to the cash voucher lag day value "has no
4 apparent basis". How do you respond?

5 A. The basis for this adjustment was the Company's response to Data Request UTI 30-11 which
6 stated that changes that increased payables processing time from 28 to 32 days was, "...done
7 in several billing systems, which account for approximately 15% of total dollars paid." From
8 this information, Staff applied a 15 percent weighting to the additional 4 days of cash voucher
9 processing time, yielding the 0.6 day adjustment ($4 \text{ days} * .15 = 0.6 \text{ days}$). These calculations
10 were contained in Staff's workpapers.

11 Q. In his discussion of Mr. Carver's SOP98-01 accounting adjustment at page 22 of Rebuttal, Mr.
12 Redding refers to a needed "adjustment to cash working capital". Is this a valid consideration?

13 A. No. At page 22, Mr. Redding states, "The next point I would like to address is the non-cash
14 nature of the accounting change. Mr. Carver has completely ignored this reality in his
15 adjustment. He has proposed to make an otherwise non-cash impacting adjustment reduce
16 cash by adopting this accounting change for regulatory purposes. To make the situation worse,
17 he fails to make an adjustment to cash working capital, which would recognize the increase
18 to cash requirements of his proposed adjustment."

19 In reality, Staff's filing requires no further adjustment to cash working capital if SOP 98-01
20 accounting is recognized. In response to Data Request UTI 69-16, the Company
21 acknowledged this, stating, "Mr. Redding's testimony at the location noted is incorrect. Staff
22 has included the effect of its SOP 98-1 accounting advocacy in its calculation of cash working
23 capital in this case. However, if the Commission adopts a different position, the effect of that
24 position will need to be incorporated into the commission's own calculation of cash working
25 capital."

- 1 Q. Do you agree that the lead lag study could be recalculated to reflect the Commission's findings
2 in preparing the rate order in this Docket?
3 A. Staff does not oppose such a recalculation.

PLANT RECORDS ADJUSTMENT

1 Q. At page 12 of his rebuttal, Mr. Wu states, "Mr. Brosch proposes a \$55.3 million reduction in
2 rate base to reflect either the retirement or the writeoff of investment that Mr. Brosch does not
3 believe is still in service." Is this an accurate statement of your testimony?

4 A. No. There is no Staff rate base adjustment for unrecorded retirements. Had Mr. Wu carefully
5 reviewed ACC Staff Schedule B-1 or my Direct Testimony at page 66, lines 6 through 11, he
6 would understand that the rate base adjustment has no impact upon rate base because of
7 FCC-prescribed mass asset accounting procedures. The only financial impact of Staff's
8 adjustment to the Company's plant records for the categories of investment set forth at
9 Schedule B-1 is to eliminate depreciation expense on such investment, as shown on Schedule
10 C-22, in the amount of \$2.9 million.

11 Q. Do you agree with Mr. Wu that the adjustment you sponsor is "Based on speculation that this
12 investment is [no] longer in service"?

13 A. The adjustment I sponsor is based upon the fact that the Company has failed to meet its burden
14 to demonstrate that these elements of rate base are in service and are used and useful in
15 providing service to customers. As I noted in my Direct Testimony, the Company was asked
16 to identify from a listing of the assets in question any individual items from the 1989 vintage
17 of Arizona General Purpose Computers that are no longer in service and the Company declined
18 to perform the special study or physical inventory that would be required. It is quite unusual
19 for the single largest vintage of an account containing computer technologies, such as mini and
20 micro-computers, terminals, data communications equipment and other computer peripherals,
21 to be ten years old. The ELG projection life for such assets is only five years, according to the
22 Company's response to Data Request WDA 34-27. I believe it entirely speculative for the
23 Company to include such assets in Arizona revenue requirements without satisfying Staff's
24 inquiries that at least some or most of the assets in question remain in service.

1 Q. According to Mr. Wu's rebuttal at page 13, "The general computer account consists not only
2 of computers, but also peripheral equipment. Examples of peripherals include power
3 equipment, printers and 'dumb' terminals." Were you aware of these other assets included
4 within the 1989 computer vintage records?

5 A. Yes. The listing of assets USWC was asked (and declined) to verify service status from
6 indicates that these types of peripherals were included in the 1989 vintage investment balances.
7 A fairly insignificant portion of the \$24 million total is indicated to be power equipment or
8 printers. Terminal units make up a somewhat larger share of the investment, but USWC has
9 done nothing to verify that any of this plant remains in service. Other examples of peripherals
10 in the \$24 million balance include data communications equipment, local area network
11 controllers and mainframe disk drives. All of this type of equipment is subject to technological
12 obsolescence and is unlikely to be in productive use by USWC ten years after installation.

13 Q. At page 14 of his rebuttal, Mr. Wu states, "When older technology is retired, where possible,
14 the remaining investment used to support the successor technology is transferred to the
15 successor's account, but the remaining investment keeps its original vintage placement date."
16 Does this testimony support a conclusion that your adjustment is inappropriate?

17 A. In theory, it might. The transfer of older 1955 assets for reuse with subsequent technology
18 might explain some of the extremely old vintages of digital circuit and switch investment on
19 Arizona books. However, in response to Staff discovery on this point, Mr. Wu admitted, "In
20 further reviewing vintage 1955 digital circuit and switch equipment, all had the wrong
21 placement year assigned. None of the vintage 1955 digital circuit and switch investment was
22 from a predecessor account."

23 Q. At pages 15 and 16 of his rebuttal, Mr. Wu argues that your depreciation adjustment for
24 unrecorded retirements should be offset by a recalculation of higher depreciation accrual rates
25 as if the retirements were recorded prior to a depreciation study. Is such a hypothetical
26 retirement recalculation of accrual rates necessary or appropriate?

1 A. It would be reasonable to consider the effects of accounting corrections to booked plant
2 investment in the next depreciation study, after any corrections for unrecorded retirements have
3 been verified by physical audit and recorded on the books. At such time, the final outcome of
4 the unresolved FCC audit adjustments to USWC's continuing property records might also be
5 considered. It is not necessary to retroactively restate the most recent completed depreciation
6 study for unrecorded retirements that are discovered in physical audits of plant. Notably, the
7 FCC audit referenced in my Direct Testimony did not specify any depreciation study
8 restatement as a result of the central office equipment that could not be verified by the auditors.

9 Q. Assuming for the sake of argument that Mr. Wu's rebuttal recalculation of depreciation accrual
10 rates for unrecorded retirements at page 16 is necessary, are the calculations shown at lines
11 14 through 16 accurate?

12 A. Staff witness Mr. Dunkel addresses these calculations and refutes Mr. Wu's results in his
13 Surrebuttal Testimony.

14 Q. Mr. Wu also disputes your treatment of 1925 metallic cable as an unrecorded retirement and
15 states, "As we explained to Mr. Brosch, the accounting system assigns a year of placement of
16 1901 when the asset's actual vintage year is not identified. This could be plant placed in 1985
17 or 1999." Is this statement consistent with the Company's responses to Staff discovery?

18 A. No. In its response to Data Request UTI 52-10, the Company stated, "Certain Outside Plant
19 assets were not kept with vintage data prior to 1989. These assets are assigned a 'fictitious'
20 year of 1901 on the accounting records." If this reference to "...not kept with vintage data prior
21 to 1989" is true, the problem with USWC's records cannot relate to any plant placed in 1999.

22 Q. Has the Company made any effort in its rebuttal evidence to verify by sampling or physical
23 inspection that any of the older vintage plant assets challenged by Staff are in service or should
24 be retired?

25 A. No.

SALE OF EXCHANGES

1 Q. What response to your proposed adjustments to the exchange sale allocations is contained in
2 the Company's rebuttal evidence?

3 A. Mr. Redding objects to the additional allocation of marketing expenses in Staff Adjustment
4 Schedule C-29, claiming that "It is fact that Qwest does very little marketing in the exchanges
5 offered for sale. The Company's adjustment reflects reality. There are no marketing people
6 located in the exchanges offered for sale. Qwest's TV, newspaper, and radio media buys are
7 heavily concentrated in the metropolitan areas. Mr. Brosch does not offer any evidence that
8 Qwest's marketing efforts in the exchanges being sold is at the same level as the exchanges
9 in the rest of the state."

10 Mr. Redding also rebuts my attribution of one percent of test period corporate operations
11 expenses to the sold exchanges with the claim "Mr. Brosch talks in generalities about cutting
12 corporate operations expenses, but does not offer any specific reasoning or support for his
13 statement."

14 Q. If the Company's marketing personnel and media buys are in the major metro markets, doesn't
15 it follow that such costs will not decline upon sale of rural exchanges?

16 A. No. In truth, the marketing costs incurred by the Company are discretionary expenditures,
17 driven by the economics of increased sales that may result from additional marketing efforts
18 and costs. This is why, as I noted in my Direct Testimony, marketing costs should be reduced
19 in proportion to the size of the market being served because the opportunity for a revenue
20 "payback" has been reduced when the exchanges are sold. It is not surprising that media buys
21 and personnel are concentrated in major metropolitan areas – this is where the most television
22 and radio broadcasts occur and where labor resources can be centralized. However, the
23 location of media does not define the scope of the markets being reached. Similarly, the
24 location of marketing personnel does not define the scope of markets they serve. Mr. Redding

1 seems to presume that because the marketing moneys are spent in the cities, no messages reach
2 the small towns. This makes little sense unless we are to assume that USWC has historically
3 ignored and left unserved the demands in its smaller markets.

4 Q. Is your corporate operations allocation at one percent to the sold exchanges based upon any
5 specific reasoning or support?

6 A. Yes. I explained in my Direct Testimony that affiliate charges to USWC from the parent
7 company are based upon relative-size-based allocation factors. Thus, when USWC becomes
8 smaller relative to Dex, Long Distance and the other affiliates, the share of parent costs
9 chargeable to USWC in Arizona will decline. In addition, the immediate effect of the Arizona
10 access line sale is a reduction in the relative size of Arizona business in relation to other
11 USWC states, such that corporate expenses that are pro-rated to Arizona will decline.

12 Q. Mr. Redding seems to dispute this pro-rate effect in his rebuttal, stating, "Arizona is one of
13 Qwest's fastest growing states. Average annual growth in access lines exceeds the number of
14 access lines that Qwest is selling in Arizona. During the regulatory approval process Qwest
15 will have added more new lines than were sold to Citizens. Taking into account growth and
16 all other factors, Arizona will have a higher corporate prorate factor in the future even with the
17 exchange sales." How do you respond to these claims?

18 A. Mr. Redding is improperly mixing other issues such as general demand growth with the
19 exchange sale effects in Arizona. It is true that Arizona growth may continue to occur in the
20 future and influence prorate factors. However, this growth phenomena is not an immediate
21 effect of the exchange sale transaction and should not be part of the analysis of exchange sale
22 effects.

RECIPROCAL COMPENSATION

1 Q. What rebuttal is offered by the Company with respect to reciprocal compensation costs?

2 A. Mr. Redding claims that my inclusion of reciprocal compensation costs within revenue
3 requirements is acceptable, but he objects because such approach "... makes no provision for
4 the future. This item is very volatile and can increase or decrease rapidly." According to Mr.
5 Redding, "This is why the Company proposed its automatic rider. The rider protects all
6 parties, regardless of whether the cost increases or decreases."

7 Q. Has Mr. Redding addressed any of the six bullet point reasons you set forth in Direct
8 Testimony as reasons why automatic rate rider treatment of this cost is inappropriate?

9 A. No. The Company has offered no credible estimates of its future exposure to reciprocal
10 compensation to justify special single-issue ratemaking for this element of the revenue
11 requirement. There is no evidence that the Company's financial condition will be jeopardized
12 by changes in reciprocal compensation. Parties to this proceeding should not be allowed to
13 isolate individual costs for special rate treatment and shift the risk of cost changes to ratepayers
14 without compelling evidence of a need to depart from traditional and balanced review of all
15 revenue requirements within a test period.

16 Q. Aside from the Company's request for extraordinary automatic rate rider treatment for
17 reciprocal compensation, is there any needed correction to the Staff's adjustment for reciprocal
18 compensation?

19 A. Yes. Staff relied upon the Company's response to Data Request UTI 62-18 for the amounts
20 of reciprocal compensation expense recorded in the 1999 test period. After Staff's filing was
21 prepared, the Company submitted a corrected and revised response to this request. I have
22 attached as Surrebuttal Appendix MLB-1 a copy of a Revised Schedule C-30 reflective of this
23 change, which increases Staff's revenue requirement by approximately \$130,000.

U S WEST, INC. DISALLOWANCES

1 Q. Does Mr. Redding disagree with Staff's disallowance of U S West, Inc. allocated parent
2 company charges?

3 A. Yes. However, only generalized statements that such functions are "necessary to any large
4 corporation" and are "usual and normal to the operation of any business" are offered at page
5 47 of his rebuttal.

6 Q. Did these representations apply to U S West, Inc. and its allocated costs that were disallowed
7 by the Commission in the Company's prior Arizona rate case?

8 A. Yes. The nature of the parent entities business functions has not appreciably changed since
9 the last rate case. I explained the Commission's prior rationale for adjustment of parent
10 company allocated costs in the last case, and related this rationale to the functions performed
11 in the 1999 test period in my Direct Testimony.

12 Q. Mr. Redding also claims in rebuttal that the parent company's "...executives are responsible
13 for structure and organization as well as policy, future direction, and focus for the Company
14 as a whole." Does this mean that an allocation of all of such costs should be charged to USWC
15 customers?

16 A. No. Certain of the parent entity's costs are not required for USWC's business operation, but
17 rather are holding company portfolio management costs that are rightfully retained by the
18 parent organization as an offset to its income.

19 Q. Does this conclude your Surrebuttal Testimony?

20 A. Yes.

Witness: M. Brosch
Prefiled Direct Testimony

Surrebuttal Appendix MLB-1
Page 1 of 1
US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
RECIPROCAL COMPENSATION
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

REVISED
ACC Staff
Schedule C-30
Page 1 of 1

LINE NO.	DESCRIPTION	SOURCE	TEST PERIOD RECORDED REVENUES	TEST PERIOD RECORDED EXPENSES	NET COST OF INTRASTATE RECIPROCAL COMP.
	(A)	(B)	(C)	(D)	(E)
1	Recorded Test Period Reciprocal Compensation - Eliminated by	Co Adj. W/Ps	\$6,561	\$18,112	\$11,551
2	ACC STAFF ADJUSTMENT TO RESTATE RECIPROCAL COMPENSATION AT TEST PERIOD RECORDED LEVELS				<u>(\$11,551)</u>

**PREPARED SURREBUTTAL TESTIMONY OF
STEVEN C. CARVER
TABLE OF CONTENTS**

**US WEST COMMUNICATIONS, INC.
DOCKET NO. T-1051B-99-105**

Issue Area	Page Reference	ACC Staff Accounting Schedules
Executive Summary	2	N/A
Test Year Results	5	N/A
EOP Nonlabor Reversal	11	C-10
SOP 98-1 (Internal-Use-Software)	17	C-13, B-2
Post-Test Year Wage & Salary Increases	24	C-14
Image Advertising, Olympic/Sports Sponsorship	30	C-27
FCC Deregulated Services	34	C-17, C-18, B-7
Incentive Compensation	36	C-12
FAS87 Pension Asset	49	B-3

**BEFORE THE
ARIZONA CORPORATION COMMISSION
PREPARED SURREBUTTAL TESTIMONY OF
STEVEN C. CARVER**

**US WEST COMMUNICATIONS, INC.
DOCKET NO. T-1051B-99-105**

1 Q. Please state your name and business address.

2 A. My name is Steven C. Carver. My business address is 740 North Blue Parkway, Suite 204,
3 Lee's Summit, Missouri 64086.

4 Q. Are you the same Steven C. Carver who filed direct testimony on behalf of the ACC Staff in
5 this proceeding?

6 A. Yes.

7 Q. Are you aware that U S WEST has undergone a name change during the pendency of this
8 docket?

9 A. Yes. As indicated in my direct testimony, U S WEST and Qwest Communications ("Qwest")
10 recently consummated a merger of the two companies. Although Qwest is the surviving
11 corporation, the pending docket was filed and has, by and large, been processed prior to
12 completion of the merger. For reference purposes, my surrebuttal testimony will continue to
13 address the Company as "USWC" or "U S WEST" – rather than Qwest.

14 Q. What is the purpose of your surrebuttal testimony?

15 A. My surrebuttal testimony will address portions of the rebuttal testimonies of two Company
16 witnesses. In the context of the rebuttal testimony of Mr. George Redding, I will address test
17 year results; the Company's end-of-period ("EOP") non-labor expense annualization; SOP 98-
18 1; post-test year wage & salary increases; image advertising and Olympic/ sports sponsorship
19 costs; and clarify the Staff's position on FCC Deregulated Services imputation. Concerning
20 Mr. Grate's rebuttal testimony, I will discuss both the incentive compensation and pension
21 asset issues.

EXECUTIVE SUMMARY

1 Q. Has the Company's rebuttal evidence caused you to revise any of the adjustments that are
2 addressed in your direct testimony?

3 A. No. Based on my review of the Company's rebuttal filing, I have not identified any
4 modifications that are required to the quantification of the various adjustments set forth in my
5 direct testimony. Based on recommendations to be addressed in the surrebuttal testimony of
6 Mr. William Dunkel, I have reflected a few relatively minor revisions to the depreciation
7 annualization set forth on ACC Staff Adjustment C-15. This revised schedule has been
8 attached as Surrebuttal Appendix SCC-5.

9 Q. Please describe the differences in the approach to the test year between the Company and Staff.

10 A. In general, the rebuttal testimony of Mr. Redding discusses the basic regulatory theory
11 underlying the ratemaking process (page 3) and presents a "test" of the proposals of the
12 Company, Staff and RUCO "to see if they fulfill the purpose of a properly adjusted test year"
13 (pages 8-9). I disagree with Mr. Redding's conclusion for two reasons:

- 14 1. the purpose of an historic test year is not to estimate precise levels of net operating
15 income or rate base expected to be experienced in future periods, and
- 16 2. his "test" results offer inconsistent and misleading comparisons.

17 Q. Please summarize the status of the difference between the Company and Staff in the
18 annualization of non-labor operating expenses.

19 A. In general, the Company based its annualization of non-labor operating expenses using a
20 "December 1999 times 12 methodology." In rebuttal, Mr. Redding presents a graph (Rebuttal
21 Exhibit GAR-R2) purporting to show that the Company's method yields reasonable results,
22 while the Staff and RUCO methodologies result in revenue requirements that are "sorely
23 deficient." This result was predetermined even before Mr. Redding assembled this exhibit –

1 because the comparison is flawed. If the Company's analysis is modified to exclude the effect
2 of Staff proposed adjustments (image advertising/ sports sponsorship, incentive compensation,
3 service quality, and SOP 98-1) from historic cost levels, the result shows that the Staff's
4 proposed level operating expense is more representative than the level recommended by the
5 Company.

6 Q. Does your surrebuttal testimony address other issues covered by Mr. Redding's rebuttal
7 testimony?

8 A. Yes. Mr. Redding and I disagree on the appropriate regulatory treatment for internal-use
9 software. I recommend capitalization consistent with SOP 98-1 while Mr. Redding supports
10 continued expensing. We also disagree on the ratemaking treatment of post-test year wage and
11 salary increases as well as image advertising and Olympic/ sports sponsorship costs. The
12 Company proposes inclusion while the Staff recommends exclusion of such costs.

13 Mr. Redding concurs with the "end result" but not the methodology proposed by the Staff with
14 regard to FCC Deregulated Services. However, because of the approach employed, my
15 surrebuttal testimony clarifies the Staff's position on the interrelationship between FCC
16 deregulated services and the jurisdictional separation of various other adjustments proposed
17 by the parties.

18 Q. Please summarize your surrebuttal regarding the incentive compensation issue.

19 A. Mr. Grate suggests that the costs of all Company's incentive compensation plans are
20 reasonable and recommends their inclusion in revenue requirement. I discuss the ABP, STIP
21 and LTIP incentive compensation plans and explain why the cost of these plans are not
22 reasonable to be borne by the Company's Arizona ratepayers. Generally, these incentive plans
23 are primarily driven by corporate-wide financial results or surveys to assess the perceptions of
24 the Company by both customers and non-customers. Corporate-wide objectives do not address

1 or define performance expectations that are unique to Arizona or the specific work activity of
2 common groups of employees. The surveys do not focus on service quality in Arizona. The
3 Company has not demonstrated the degree to which these corporate-wide objectives have
4 resulted in achievement levels unlikely to be attained in the absence of such plans or created
5 benefits for Arizona ratepayers that could not have been attained otherwise.

6 Q. Please summarize your surrebuttal regarding the pension asset issue.

7 A. Mr. Grate and I also disagree on whether the pension asset should be included in rate base.
8 Both my direct and surrebuttal testimonies as well as Mr. Grate's rebuttal testimony discuss
9 this issue in significant detail. Mr. Grate contends that "ratepayers always benefit" from the
10 Company's recording of pension credits, but this concept of cost recovery is not consistently
11 followed by the Company. I contend that the Company has failed to demonstrate that
12 ratepayers have received the full benefit of the pension credits such that the pension asset
13 should be excluded from rate base.

TEST YEAR RESULTS

1 Q. Beginning at page 3, line 12 of his rebuttal testimony, Mr. Redding discusses the basic
2 regulatory theory of the ratemaking process. Do you agree that the objective of the regulatory
3 process is to establish prospective rates that will be in effect during future periods?

4 A. Yes. In Arizona, utility rates are typically based on an historic, but adjusted, test year. Any
5 change in overall revenue requirement is only implemented, by definition, on a prospective
6 basis.

7 Q. At page 4, line 7, Mr. Redding states:

8 "The purpose of the test year is to estimate, to the best extent possible, the
9 conditions that will exist when rates from this proceeding will go into effect."

10 Do you agree?

11 A. I generally concur with this statement, but feel compelled to qualify the nature of my
12 concurrence. A test year is used to determine the various components of the ratemaking
13 equation (rate base, revenues, expenses and weighted cost of capital) in order to quantify
14 overall revenue requirement and establish tariff rates. It is these resulting tariff rates that are
15 effective in future periods.

16 Unless a fully forecasted test year is employed, the ratemaking framework does not attempt and
17 should not be presumed to estimate the level of rate base, revenues, expenses and weighted
18 cost of capital expected to occur during the rate effective future period. When an historic test
19 is used, the adjusted test year data does not typically represent the level of volumes/ quantities
20 and prices expected in the future rate-effective period. So, the results from the historic test
21 period should not be expected to match future levels of rate base, revenues, expenses and
22 capital costs.

1 Q. If an historic test year can not be expected to match or predict future levels of rate base,
2 revenues, expenses and capital costs, can a regulated entity reasonably expect to have an
3 opportunity to earn a reasonable return on its investment?

4 A. Yes. In the context of an historic test year, it is known that each component of the ratemaking
5 formula will change immediately following the end of that historic period. So, instead of
6 trying to estimate or predict future revenue or expense levels, the historic test year ultimately
7 results in a series of relationships between the various components of the ratemaking formula
8 (rate base, revenues, expenses and capital weighted costs). The resulting revenue requirement
9 is then used to determine tariff rates and charges that will be applied to actual levels of
10 customer subscriptions to the various products and services offered subsequent to the test year.
11 It is expected that future customer subscription levels will be different from the levels on which
12 test year revenues were established – just as future levels of rate base and expenses are also
13 expected to be different.

14 As long as the test year reasonably balances the various components of the ratemaking formula,
15 the resulting prices charged to future customers will still afford the utility an opportunity to
16 earn a reasonable return on investment – even if the test year was not specifically designed or
17 intended to forecast the level of revenues and expenses expected to be realized during the rate
18 effective period.

19 In order to achieve a reasonable “balance,” it is important to consistently value quantities or
20 volumes (access lines, minutes of use, employee levels, number of bills mailed, number of
21 magazine subscriptions, number of professional memberships, etc.) and prices (wage/ salary
22 rates, postage costs, renewal rates, etc.). If consistency is not achieved for those items
23 materially influencing the cost of service, the resulting revenue requirement may yield results
24 that skew (either high or low) the utility’s opportunity to achieve a return other than that
25 authorized.

1 Q. Has any party to this proceeding suggested that a forecast test year be employed?

2 A. No. However, it is a forecast test year, not an historic test year, that is explicitly designed to
3 quantify future levels of revenue, expense and investment.

4 Q. In the context of a fully forecasted test year, are forecast estimates of quantities and prices
5 undertaken?

6 A. Yes. While a forecast test year may be valued using an average or year-end approach, it is
7 imperative that volumes and prices be consistently forecast into the future. So, a forecast test
8 year is a "best efforts" attempt to estimate future quantities and prices. In my experience, the
9 use of a forecast test year does not simplify the ratemaking process – it changes the types of
10 valuation issues that arise between the parties.

11 Q. Beginning at page 8 of his rebuttal, Mr. Redding presents a "test" of the proposals of the
12 Company, Staff and RUCO "to see if they fulfill the purpose of a properly adjusted test year."
13 Are you familiar with this portion of Mr. Redding's rebuttal testimony?

14 A. Yes. Referring to the table on page 9 of his rebuttal testimony, Mr. Redding annualizes the
15 actual net operating income realized during the first five months of 2000, adds the net
16 operating income ("NOI") value of the recommendations of the various parties and then
17 quantifies a return on investment using May 2000 average net investment. This "test" was
18 used by Mr. Redding to conclude that the recommendations of the Staff and RUCO will
19 "completely miss the mark of approximating the conditions that will be in effect when rates
20 from this proceeding go into effect" and "will not provide sufficient revenues to generate the
21 required rate of return."

22 Q. Do you concur with Mr. Redding's conclusion?

23 A. No. I disagree with Mr. Redding's conclusion for two reasons. First, as discussed previously,
24 an historic test year was never intended to estimate, with precision, levels of net operating
25 income or rate base expected to be experienced in future periods. Nonetheless, it will certainly

1 provide a reliable basis for revenue requirement estimation purposes. Second, Mr. Redding's
2 quantification of this "test" offers an inconsistent comparison and appears to be intentionally
3 misleading.

4 Q. Could you please summarize your quantification concerns with respect to this table?

5 A. Yes. In quantifying the \$61,973,000, the Company annualized the May 2000 intrastate NOI
6 by simply multiplying the YTD as recorded intrastate net operating income by a factor of
7 12/5^{ths}. USWC has made no attempt to modify the "as recorded" NOI amounts for any of the
8 following items, typically reviewed and adjusted during a rate case analysis of revenues and
9 expenses:

- 10 • out-of-period or prior period journal transactions
- 11 • abnormal or non-recurring transactions
- 12 • proposed regulatory disallowances or accounting changes

13 Q. Why do you believe that Mr. Redding's "test" is inconsistent?

14 A. In quantifying the level of net operating income underlying the recommended revenue
15 requirement, the Staff has proposed a variety of ratemaking adjustments. The NOI effect of
16 these adjustments is included within the \$4,261,000 deficiency contained in the Staff's direct
17 filing that is identified as "Staff NOI Value of Revenue Requirement/ Deficiency" in Mr.
18 Redding's table. However, the \$61,973,000 (representing year-to-date May 2000 annualized
19 net operating income) has not been similarly adjusted for consistency with the NOI deficiency
20 proposed by Staff.

21 For example, the Staff's computation of the \$4,261,000 NOI deficiency incorporates the
22 imputation of Directory Revenues, the capitalization of Internal-Use Software consistent with
23 SOP 98-1, the elimination of certain incentive compensation costs and the elimination of the
24 costs of image advertising/ sports sponsorships. Each of these adjustments effectively decrease
25 the Staff's proposed NOI deficiency. Further, the NOI deficiency, as well as the overall

1 revenue requirement, recommended by the ACC Staff reflects the elimination of test year costs
2 and investment associated with the access line sale to Citizens Utilities. In order to present a
3 meaningful comparison, Mr. Redding should have similarly adjusted the May 2000 YTD
4 annualized NOI and rate base amounts to reflect comparable treatments for these items. Had
5 he done so, the net effect would have been to increase the annualized May 2000 intrastate NOI
6 above the \$61,973,000.

7 Q. Why did you express concern that this "test" appears to be intentionally misleading?

8 A. ACC Staff Data Request No. UTI 69-11 specifically asked for an explanation of why the YTD
9 May 2000 NOI was not adjusted to recognize the various Staff adjustments mentioned
10 previously. To paraphrase the Company's response thereto:

11 The purpose of the table was to compare recommended revenue
12 requirements/deficiency with actual 2000 results. Ratemaking adjustments for
13 directory advertising, image advertising, incentive compensation, access line
14 sale, etc. are not made in actual results.
15 [ACC Staff Data Request No. UTI 69-11]

16 If ratemaking adjustments were included in actual results, there would be no need for the
17 ratemaking adjustments to begin with. It appears that the Company intentionally decided to
18 not adjust the YTD May 2000 NOI or rate base amounts for out-of-period, abnormal,
19 nonrecurring items or to otherwise reflect consistency with the Staff's proposed revenue
20 requirement adjustments. This led me to conclude that the comparative results appeared to be
21 intentionally misleading.

22 Q. Would the recognition of these various "consistency" adjustments influence the "Return on
23 Avg. Net Investment" as presented in the table set forth on page 98 of Mr. Redding's rebuttal
24 testimony?

25 A. Yes. In general terms, I would expect the returns on investment in the Staff and RUCO
26 columns of this table to increase if these consistency adjustments were prepared. However,

1 I have not attempted to present alternative return calculations, because no detailed analyses
2 have been conducted on the actual revenues or expenses recorded during the period January -
3 May 2000 to identify and quantify other adjustments that may be required to properly restate
4 revenues and expenses for comparative purposes. As indicated by the response to ACC Staff
5 Data Request No. UTI 69-10, the Company's analysis does not incorporate any such
6 adjustments.

7 Q. Why should any of these adjustments be of concern in presenting this type of comparison?

8 A. Mr. Redding's stated purpose was to "test" the proposals of the Company, Staff and RUCO
9 "to see if they fulfill the purpose of a properly adjusted test year." Assume that the
10 Commission were to agree with the Staff that all image advertising and sports sponsorship
11 costs should be excluded from rates. If USWC/ Qwest makes the conscious decision to
12 continue funding these types of activities, it is entirely reasonable for the Company to expect
13 downward pressure on its achieved return – as rates were not intended to explicitly allow for
14 recovery of these disallowed costs. By comparing the 9.68% Staff "Recommended Rate of
15 Return" with Mr. Redding's calculation of the 4.06% Staff "Return on Avg. Net Investment",
16 the Company is merely complaining that its earnings will be short and failing to recognize that
17 some portion of the short-fall is controlled by the Company itself. This is not a valid criticism
18 of the adjustment recommendations proposed by Staff.

EOP NONLABOR REVERSAL

1 Q. Beginning at page 11 of his rebuttal testimony, Mr. Redding is critical of your comments
2 regarding the Company's end-of-period annualization adjustment. Are you familiar with that
3 portion of Mr. Redding's rebuttal?

4 A. Yes. I have reviewed Mr. Redding's testimony and his allegations that my direct testimony
5 attempts to discredit the Company's methodology by: "glossing over the details," "fogging the
6 main point," "picking and choosing" or obfuscating the main purpose of the annualization.

7 Q. Do you agree with these criticisms?

8 A. Absolutely not. While I do not question Mr. Redding's representation, at rebuttal page 12, that
9 the Company's EOP annualization adjustment "took a great deal of time and analysis," this
10 does not change the fact that the Company's high-level annualization technique summarily
11 over-rides millions of accounting transactions recorded each year for the sake of year-end
12 "consistency."

13 Also, I find it incredible that Mr. Redding would make the claim that "estimates are not made
14 more meaningful or accurate by being 'more detailed' or 'precise'." [Redding rebuttal, p. 14]
15 The millions of transactions recorded each year are based on "detailed" invoices and other
16 accounting records that must be "precise" and accurate. However, as shown by Mr. Redding's
17 Rebuttal Exhibit GAR-R2, recorded intrastate expense levels fluctuate dramatically from
18 month-to-month. As a consequence, I believe that such gyrations require and demand even
19 more detail and precision – if a one-month times twelve annualization technique is employed.

20 Q. At pages 15 through 18, Mr. Redding introduces Rebuttal Exhibits GAR-R1, GAR-R2 and
21 GAR-R3 which compare historical monthly results from the period January 1997 through May
22 2000 with overlays of the proforma levels proposed by Company, Staff and RUCO. Have you
23 reviewed these graphs?

1 A. Yes. Mr. Redding contends that the comparisons between historic results and the Company's
2 end-of-period proforma levels offered in my direct testimony present "apples and oranges."
3 He believes that a more appropriate measure of the reasonableness of the adjustment results
4 would be achieved by a comparison with future levels – thereby demonstrating that Staff's
5 reliance on historical results is "misleading and inappropriate." In assembling these rebuttal
6 graphs, Mr. Redding chose to exclude the effect of certain revenues and costs for comparison
7 purposes:

- 8 • deregulated results,
- 9 • directory imputation, and
- 10 • sale of exchanges.

11 According to Mr. Redding (rebuttal, p. 20), the Company represents that these graphs
12 "demonstrate that the Company's method, which was done at an overall level is not improved
13 by digging around in the details." Interestingly, Mr. Redding concludes that Rebuttal Exhibits
14 GAR-R1 and GAR-R3 show that the parties are "very close" in operating revenues (except for
15 directory imputation) and "quite close" on total depreciation – presumably supporting his
16 contention.

17 However, Mr. Redding goes on to state that the comparison "really falls apart" in the context
18 of "Expenses Other than Depreciation" [Rebuttal Exhibit GAR-R2]. Mr. Redding contends
19 that this exhibit shows that the Staff's recommended expense levels are "significantly below
20 actual levels" being incurred and results in "suggested revenue requirements [that] are sorely
21 deficient."

22 Q. Do you have any comments with respect to Rebuttal Exhibit GAR-R2?

23 A. It is not surprising that the results set forth on Rebuttal Exhibit GAR-R2 show the Company's
24 expense levels much closer than amounts from the Staff's filing to the actual levels recorded

1 during January through May 2000. This result was predetermined even before Mr. Redding
2 assembled the graph – because Rebuttal Exhibit GAR-R2 is flawed by its own form of the
3 “apples and oranges” comparison for which the graphs in my direct testimony were criticized.

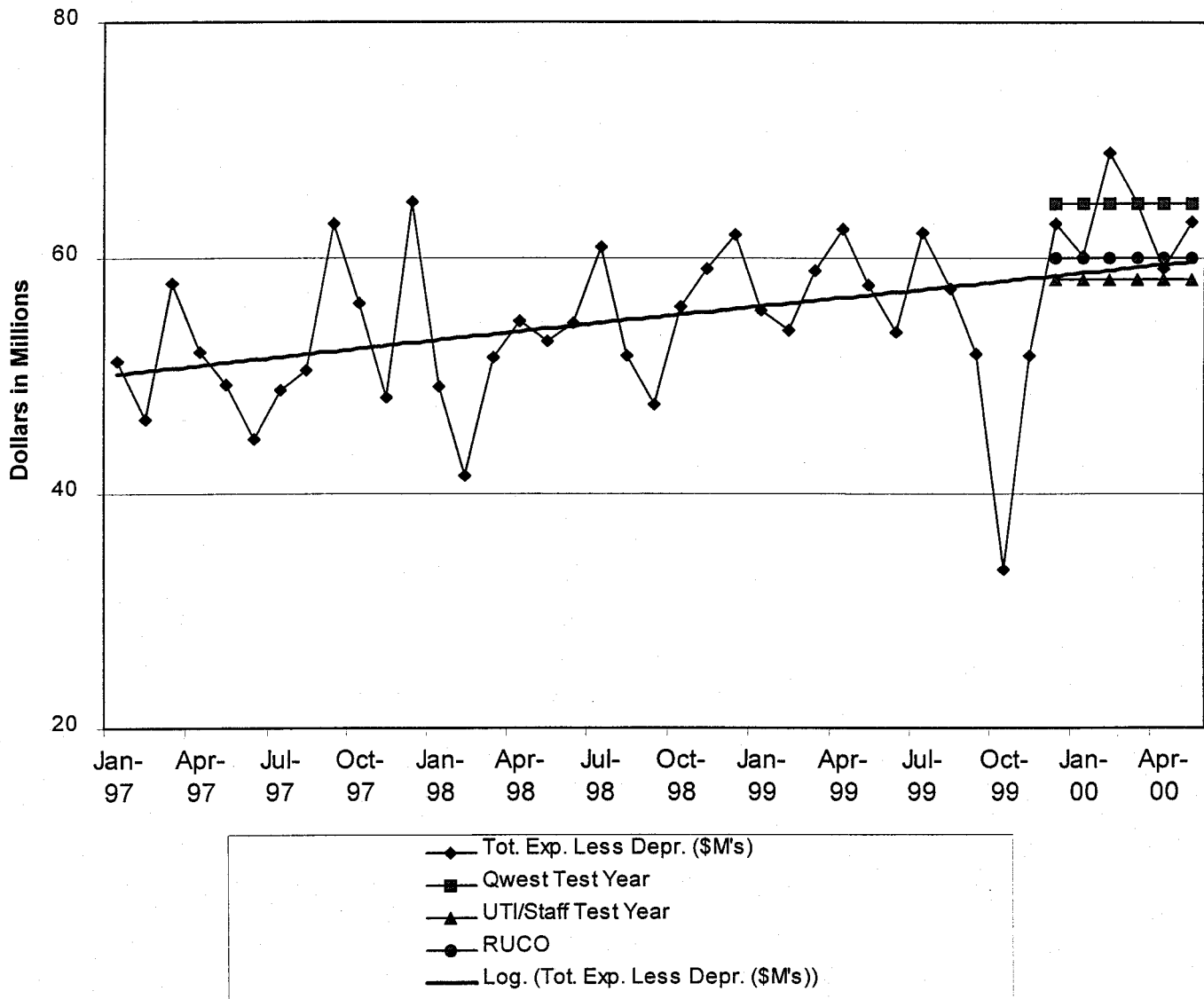
4 Q. Please explain.

5 A. The monthly data and the associated trend line for the period January 1997 through May 2000
6 set forth on Rebuttal Exhibit GAR-R2 are based on “per book” or “as recorded” results. Such
7 amounts include the “as recorded” costs of image advertising/ sports sponsorship, incentive
8 compensation, service quality, and SOP 98-1 that the Staff has proposed to disallow, in whole
9 or in part, for ratemaking purposes. Since the Company has incurred such costs and has not
10 proposed to disallow the cost of these items, it should be expected that Exhibit GAR-R2 would
11 reflect a better “fit” between USWC’s proforma expense levels and the regression trend line
12 as well as the actual levels achieved subsequent to the test year. In essence, the graph does
13 represent an “apples to apples” comparison for limited comparison with USWC’s proforma
14 expense levels.

15 However, this is not true for comparison with the Staff’s filing. If the Company’s analysis
16 presented as Rebuttal Exhibit GAR-R2 is modified to exclude the costs associated with the
17 Staff’s proposed treatment of these items (image advertising/ sports sponsorship, incentive
18 compensation, service quality, and SOP 98-1) from the monthly data and trend line, the
19 resulting graph shows that the Staff’s proposed expense level is more representative of ongoing
20 conditions than the Company’s – to paraphrase Mr. Redding’s rebuttal testimony at page 16.

21 Although I remain concerned that the post-test year data has not been reviewed and analyzed in
22 detail for possible adjustment, the following graph illustrates the result of simply modifying
23 the recorded expenses underlying the Company’s Rebuttal Exhibit GAR-R2 for “consistency”
24 with these four Staff adjustments:

Qwest Corporation
Arizona Intrastate Operations
Comparison of Company, Staff and RUCO
Intrastate Expenses less Depreciation, SOP 98-1, Image
Advert, Service Quality, & Incentive Comp



- 1 This revision to Rebuttal Exhibit GAR-R2 represents more of an “apples to apples”
2 comparison with the Staff’s filed revenue requirement.

1 Q. How can the same basic analysis appear to support both the Staff and Company proforma
2 expense levels?

3 A. As filed, Mr. Redding (rebuttal page 17) used Rebuttal Exhibit GAR-R2 to support his
4 conclusion that the Staff proposed revenue requirement was "sorely deficient." However, his
5 "apples to oranges" comparison with the Staff's filed amounts essentially presumed that the
6 Company should still be allowed to recover recorded expenses, even if the cost of service
7 explicitly does not allow certain costs to be recognized for ratemaking purposes. For example,
8 the Staff has proposed to disallow image advertising costs and capitalize SOP 98-1 costs. In
9 the Company's historical data, these costs were recognized on an "as recorded" basis. So, this
10 type of "apples to oranges" comparison would almost always show the Staff's proposed
11 expense levels as being deficient. However, once the analysis is modified to exclude the
12 disallowed or capitalized costs – consistent with the Staff's recommendations in this
13 proceeding – the graph results show that the Staff levels are acceptable, by historical
14 comparison standards, while the Company's proforma levels are excessively above the
15 regression trend line.

16 Q. At rebuttal page 17, Mr. Redding indicates that his exhibits demonstrate just the opposite of
17 the statement you made on page 20 of your direct testimony that "...it is notable that even
18 dramatic post-test year increases in intrastate operating expenses, as presented in the
19 underlying documentation, do not reach the extraordinarily high proforma level included in
20 USWC's proposed revenue requirement." Do you care to comment?

21 A. Yes. There are several brief points that should be addressed in this regard. First, each data
22 point on Mr. Redding's Rebuttal Exhibit GAR-R2 represents one month of data. In other
23 words, the historical data points starting in January 1997 through May 2000 each reflect one
24 month of expense. In contrast, each data point on the graph of Arizona intrastate operating
25 expense set forth on page 19 of my direct testimony instead reflects twelve months of operating
26 expense.

1 In order to prepare Rebuttal Exhibit GAR-R2, Mr. Redding was required to calculate an
2 average monthly expense using the twelve months of overall expenses recommended by the
3 Company, Staff and RUCO. As shown by Rebuttal Exhibit GAR-R2, recorded expense levels
4 fluctuate significantly from month-to-month. So, a comparison of an average monthly
5 "proposed" level, that has been smoothed by the averaging process, should be expected to
6 graphically depict a different image than the graphs I used, which relied on rolling twelve
7 months of data to enhance comparability and smooth gyrations in the underlying month-to-
8 month amounts.

9 Second, as discussed in my direct testimony, recorded expenses are the product of both prices
10 and quantities. The expenses recorded in the post-test year months of January through May
11 2000 include volume/ quantity and price level changes that were not explicitly considered in
12 either the Staff or USWC proforma expenses.

13 Third, the expenses in the months of January through May 2000 represent post-test year data
14 that the Staff has not analyzed or reviewed in detail. These expenses are presented on an "as
15 booked" basis and have not been analyzed or adjusted to eliminate the effect of any abnormal
16 transactions or unusual events included therein.

17 Finally, as indicated in the responses to ACC Staff Data Request No. UTI 69-11, UTI 69-15
18 and UTI 70-7, the objective of the Company in presenting Rebuttal Exhibit GAR-R2 was to
19 compare recommended expense levels with actual 2000 results. So, the actual data was not
20 adjusted to consider comparability with the proforma expenses recommended by Staff and
21 RUCO.

SOP 98-1 (Internal-Use Software)

1 Q. Beginning at page 18 of his rebuttal testimony, Mr. Redding discusses his opposition to the
2 adoption of SOP 98-1 for regulatory purposes. Do you have any general comments with
3 respect to the Company's rebuttal position?

4 A. Yes. Mr. Redding has not introduced any new information that was unknown at the time
5 Staff's direct testimony was filed.

6 Q. Referring to pages 19 and 20 of Mr. Redding's rebuttal testimony, do you have any comments
7 with regard to the reference to the FCC's adoption of SOP 98-1 or the proposals to move
8 USWC to price cap regulation in Arizona?

9 A. Yes. The footnote at the bottom of page 19 of Mr. Redding's rebuttal testimony refers to the
10 FCC's decision to modify its price cap rules to exclude exogenous treatment of accounting
11 changes that have no cash flow impact. The decision of how, when and whether to implement
12 a price cap plan in Arizona is one for this Commission to make. While the findings of the FCC
13 on this matter are informative, they are not determinative.

14 As outlined at pages 64-65 of my direct testimony, the Company has previously implemented
15 a variety of "accounting changes" in Arizona that had no cash flow impact – outside the
16 context of a rate proceeding. Nevertheless, USWC sought regulatory and ratemaking
17 recognition of a variety of accounting changes that were similarly "not cash affecting,"
18 including:

- 19 • capital to expense shifts resulting from the adoption of the "new" uniform system of
- 20 accounts prescribed by the FCC (i.e., Part 32);
- 21 • change in accounting from the cash method to the accrual method of accounting for
- 22 compensated absences, merit awards and medical/ dental expenses;
- 23 • increase in the capitalization rules from \$200 to \$500 and then from \$500 to \$2,000,
- 24 allowing the expensing of qualifying "small value" assets;
- 25 • adoption of revisions to depreciation accrual rates and depreciation reserve deficiency
- 26 amortizations;

- 1 • adoption of the FAS87 accrual method of accounting for pension costs; and
- 2 • adoption of FAS106, which implemented a change from cash to accrual method of
- 3 accounting for post-retirement benefits other than pensions.

4 All of these items, but the adoption of FAS87, had the effect of initially increasing the rates
5 charged USWC's ratepayers. Although those changes were "not cash affecting" until included
6 in the ratemaking process, the Company still sought regulatory approval and rate treatment.

7 The Commission has now received proposals from both the Staff and Company advocating the
8 transition from rate of return to price cap regulation. Further, the Company has filed testimony
9 discussing the changing landscape of competition in support of its request to recover
10 significant image advertising and sports sponsorship costs from ratepayers.

11 Clearly, the Company desires decreased regulation and increased flexibility. But, USWC only
12 seems interested in adopting generally accepted accounting principles for regulatory purposes
13 when the near-term effect is to increase ratepayer costs.

14 Q Referring to page 19 of Mr. Redding's rebuttal testimony, he refers to these various accounting
15 changes and states that they had "much longer lives, ranging from 7 year to 20 years" than the
16 five year period used to amortize the cost capitalized in accordance with SOP 98-1. Do you
17 have any comments on this point?

18 A. Yes. While there is no question that the range of 7 - 20 years is greater than five years, the
19 Company has adopted SOP 98-1 for public financial disclosure purposes. However, I do not
20 believe that a five year amortization period is sufficient justification to continue expensing the
21 cost of internal-use software.

22 A five year amortization period is equivalent to an amortization rate of 20%. Referring to
23 ACC Staff Schedule C-15, the Staff's annualization of book depreciation includes updated test
24 year depreciation accrual rates in excess of 16% for five plant accounts (Account 2115, Garage

1 Work Equipment; Account 2122, Furniture; Account 2123.1, Office Equipment; Account
2 2431, Aerial Wire; and Account 2424, Submarine Cable Metallic). Referring to footnote (f)
3 on revised ACC Staff Schedule C-15 (see Surrebuttal Appendix SCC-5), Mr. Dunkel has also
4 proposed a three-year amortization (i.e., a 33.3% amortization rate) for the undepreciated
5 investment in Account 2211, Analog Switching Equipment. In addition, the composite book
6 depreciation rate for the \$3.6 billion of Arizona intrastate depreciable investment set forth on
7 ACC Staff Schedule C-15 is about 9.0%, which is equivalent to a composite amortization rate
8 of about 11.1 years.

9 Q. At pages 20-21, Mr. Redding indicates that, in the first year of this accounting change, USWC/
10 Qwest would reduce software expense by approximately \$420 million, but recognize
11 amortization expense of \$42 million. Is this amortization based on a ten-year amortization
12 period?

13 A. No. In this portion of rebuttal testimony, Mr. Redding has assumed that only one-half of the
14 annual amortization expense would be recognized in the year of adoption, with a full year of
15 amortization commencing in Year 2 at \$84 million.

16 Q. At page 21, line 13, Mr. Redding states that you have taken the first year impact, which is now
17 behind the Company, and used that level of expense. Is he correct?

18 A. No. Mr. Redding's testimony is misleading on two points. First, ACC Staff Adjustment C-13
19 recognizes a full year of amortization within the test year, not the one-half year amortization
20 as implied by Mr. Redding.

21 Second, Mr. Redding seems to criticize the Staff's adjustment for recognizing the first year
22 impact. This is an interesting criticism, but not one of merit. Whenever an accounting change
23 occurs, there must always be a first year. Because the Company implemented SOP 98-1 for
24 financial reporting in 1999, the "first year" for financial purposes occurred in 1999. However,
25 this accounting change has yet to be recognized for regulatory purposes, so the first year must

1 be considered once it is adopted for regulatory purposes. ACC Staff Adjustment C-13 does
2 just that by reflecting the first year effect, including a full year of amortization not the one-half
3 year convention suggested in Company rebuttal testimony.

4 Q. Beginning at page 22 and continuing through page 24, Mr. Redding discusses an automatic
5 rider to capture the annual change in revenue requirement resulting from the regulatory
6 adoption of SOP 98-1. Do you have any comments?

7 A. Yes. First, Rebuttal Exhibit GAR-R4 and the revenue requirement amounts set forth on page
8 23 of Mr. Redding's rebuttal testimony do not employ the one-half year convention referenced
9 by Mr. Redding at pages 20-21. Second, Rebuttal Exhibit GAR-R4 effectively assumes that
10 the entire return of 10.86% is equity based, which serves to slightly overstate the return on
11 investment element of the revenue requirement model. Third, the revenue requirements set
12 forth on page 23 of Mr. Redding's rebuttal show that the annual nominal dollar effect does not
13 turn-around until year 2003 and, on a cumulative basis, does not turn-around until well after
14 2004 – more specifically in the year 2010.

15 Q. At page 23, Mr. Redding refers to a 1996 Arizona Court of Appeals decision resulting from
16 ACC Docket No. E-1051-93-183 as precedent for implementing a rate rider to track the annual
17 change in SOP 98-1 revenue requirement. Was that decision associated with a change in
18 accounting, such as compensated absences, vacation accruals or FAS106 accounting for OPEB
19 costs?

20 A. No. The Court of Appeals decision concerned the resolution of the Directory Imputation issue
21 appealed by USWC following the last Arizona rate proceeding, not the annual revenue
22 requirement effect of a change in accounting method.

23 Q. Has the Company previously proposed or implemented any rider mechanisms to capture the
24 effect of any accounting changes?

1 A. No, not that I am aware of. In response to ACC Data Request No. UTI 70-9, the Company
2 specifically indicated that it had not previously sought rate riders to capture the effect of any
3 of the following accounting changes:

- 4 • expiration of the amortization of the one-time change in compensated absences;
- 5 • year to year changes in pension costs pursuant to FAS87 accounting;
- 6 • year to year changes in FAS106 accounting for OPEB costs, including the expiration of the
7 TBO amortization;
- 8 • cessation of recording depreciation expense on plant accounts that are fully depreciated;
9 or
- 10 • capital to expense shifts resulting from the adoption of the "new" uniform system of
11 accounts prescribed by the FCC (i.e., Part 32).
12 [ACC Data Request No. UTI 70-9]

13 As mentioned previously, Mr. Dunkel has also proposed a three-year amortization for the
14 undepreciated investment in Account 2211, Analog Switching Equipment (see Surrebuttal
15 Appendix SCC-5). On an Arizona intrastate basis, this amortization proposal is equivalent to
16 \$18 million a year for three years. Maybe the Commission should also consider "tracking" the
17 offsetting effect of this amortization when it expires in three years, if the Company's proposed
18 tracker is given serious consideration.

19 Q. At rebuttal page 24, line 16, Mr. Redding states:

20 "Since adoption of a price cap plan would end rate of return regulation, at least for the
21 term of the plan, the Company could never recover these future cost increases without
22 an automatic rider."

23 Do you have any information which would help interpret this portion of Mr. Redding's rebuttal
24 testimony?

25 A. Yes. ACC Staff Data Request No. UTI 70-11 was submitted in order to specifically address
26 this rebuttal testimony. According to the response to this discovery request: The word
27 "never" is defined at least for the term of a price cap plan. Mr. Shooshan proposes a five year
28 plan." However, this same response indicates that the Company does recognize that its
29 revenues and expenses will change during the term of any price cap plan that may be adopted.

1 While no one can know with absolute certainty whether a combination of revenue growth,
2 expense decreases and improving productivity may yield earnings gains during any time period
3 or term of a price cap plan, the possibility does exist that other factors could mitigate or
4 completely offset the SOP 98-1 changes that the Company has not suggested be tracked
5 through a rate rider – such as the \$18 million annual amortization that expires in three years.

6 Q. In your direct testimony, you recommend that the Commission reverse the rate base effect of
7 a USWC proforma adjustment to recognize the depreciation reserve and deferred income tax
8 reserve effects of the increase in depreciation expense due to the recent change in book
9 depreciation rates. Is that correct?

10 A. Yes. The Staff has proposed a fairly stringent cut-off of the test year at the end of December
11 1999. Because USWC did not commence booking the revised depreciation rates reflected in
12 ACC Staff Adjustment C-15 until subsequent to the 1999 test year, ACC Staff Adjustment B-1
13 proposes to exclude the proforma effect of USWC's capital recovery adjustment from rate base
14 (i.e., both the accumulated depreciation reserve and accumulated deferred income tax reserve
15 effects).

16 However, if the Commission were to adopt a rate rider mechanism or otherwise recognize
17 additional changes in revenue requirement occurring subsequent to the test year, the
18 Commission should, at a minimum, reject ACC Staff Adjustment B-1. Other options available
19 for Commission consideration would include forecasting the growth in the depreciation reserve
20 during the term of any adopted rate cap plan or establish yet another rider mechanism to flow
21 the revenue requirement effect of the reserve growth through to ratepayers.

22 Q. Are you changing your position on the proposed treatment of the depreciation reserve?

23 A. No. But, if the Commission is inclined to adopt other post-test year changes or implement
24 automatic rate riders, why not expand the scope to include other items as well?

1 Q. Do USWC's competitors follow SOP 98-1?

2 A. Yes. SOP 98-1 is applicable to all nongovernmental entities and was effective for financial
3 statements for fiscal years beginning after December 15, 1998.

4 Q. Does the Company have any information concerning whether its competitors following SOP
5 98-1 for accounting or product pricing purposes?

6 A. Apparently not. The response to ACC Data Request No. UTI 70-10 indicates that the
7 Company does not know how or whether its competitors recognize SOP 98-1 for regulated
8 accounting or product pricing purposes. The Company's lack of information is in stark
9 contrast to Mr. Redding's rebuttal testimony on image advertising/ sports sponsorship costs.
10 At rebuttal page 39, Mr. Redding states: "Every large company I can think of, regardless of
11 industry, engages in image advertising and includes in its price an element of that cost."

POST-TEST YEAR WAGE & SALARY INCREASES

1 Q. At page 27 of his rebuttal testimony, Mr. Redding disagrees with your direct testimony at page
2 69 where you state: "In a sense, the update of the test year from June 1998 to calendar year
3 1999 is an exercise encompassing an 18 month known and measurable period update." Do you
4 have any comments on Mr. Redding's characterization of your testimony?

5 A. Yes. Mr. Redding characterizes this testimony as "incredible," "nothing could be farther from
6 reality," and "pure obfuscation." Obviously, Mr. Redding and I disagree on this subject. The
7 Company has sought recognition of the post-test year wage and salary increases on a piecemeal
8 basis, attempting to find solace in not recognizing any changes to volumes subsequent to the
9 test year.

10 The fact remains that every element of the ratemaking equation will and does change over
11 time. The purpose of this portion of my testimony was to point to both the Company's original
12 and update filings so as to observe that, despite an 18 month change in the test year, USWC's
13 overall revenue requirement resulted in a fairly limited change – a fact not addressed by Mr.
14 Redding. Wage and salary rates also changed during that 18 month period, but so did other
15 prices and other volumes. As stated at page 69, lines 13-15, of my direct testimony, the net
16 effect of this test year updated process resulted in "...a fairly limited change in the Company's
17 filed revenue deficiencies – evidence demonstrating why piecemeal ratemaking should be
18 avoided."

19 Q. At page 27, line 15, Mr. Redding appears to be rebutting a statement you made that is
20 inconsistent with Mr. Brosch. Do you recall stating in direct testimony that the Staff has made
21 no out-of-period adjustments?

22 A. No. I do not recall any such testimony. Unfortunately, Mr. Redding does not provide a
23 citation to the testimony he purports to rebut. In any event, I have attempted to be careful in
24 characterizing the Staff's approach as using a "relatively stringent" test year cut-off. This

1 phraseology appears on pages 15 and 68 of my direct testimony. Presumably, Mr. Redding
2 was intending to rebut my testimony at page 68.

3 Q. Do you deny that the Staff has proposed to recognize certain changes that have or will occur
4 subsequent to the test year?

5 A. No. I do not and have not taken such a position. Referring to page 15 of my direct testimony,
6 I state:

7 While the Staff has endeavored to apply a relatively stringent test year approach in
8 order to consistently value the various components of the ratemaking equation, there
9 are unique circumstances currently affecting the Company's operations which deserve
10 and demand recognition in the quantification of overall revenue requirement. As the
11 Commission is aware, the Company has negotiated, but not yet closed, an agreement
12 to sell certain rural Arizona exchanges. Also, the pending rate proceeding is the result
13 of a lengthy docket before this Commission concerning various revisions to USWC's
14 Arizona depreciation rates, which was not concluded until after the 1999 test year.
15 Further, the Company initiated a separate proceeding to transfer certain broadband
16 assets to a non-regulated affiliate. Although the procedural schedule in the latter
17 proceeding has been delayed, each of these matters uniquely affect the Company's
18 operating results in the State of Arizona.

19 Beyond adjustments for the exchange sale, depreciation accrual rates and broadband
20 transfer, the Staff has proposed specific adjustments to annualize discrete, identifiable
21 components of revenues and expenses to test year-end. Although the Company may
22 attempt to characterize this approach as "picking and choosing" or leading "to a great
23 deal of mischief," it is important to recognize that some revenues and expenses are
24 reasonably stated at actual recorded levels, in the absence of detailed information
25 demonstrating otherwise.

26 [Carver Direct, p.15, Emphasis Added]

27 I chose brevity at page 68 of my direct, rather than restate what was already said earlier. In any
28 event, I do not believe that my testimony at page 68 contradicts this excerpt from page 15.
29 Further, the wage and salary increases granted in the year 2000 are neither unique nor
30 compelling. The Company has a long history of granting annual increases in this manner.

1 Q. At page 28 of his rebuttal testimony, Mr. Redding introduces excerpts from your response to
2 an unidentified discovery request in the pending New Mexico rate case to conclude that you
3 have contradicted your own position. Is that true?

4 A. No. It is now Mr. Redding who tries his hand at obfuscation. My direct testimony does not
5 state that no adjustments outside of the test year are ever warranted or adopted by other
6 commissions. While Mr. Redding does accurately quote from my response to Data Request
7 No. USW 02-202 in Utility Case No. 3008 currently pending before the New Mexico Public
8 Regulation Commission, the excerpt is too selective, so as to be misleading. Surrebuttal
9 Appendix SCC-1 represents a reproduction of the Company's interrogatory and my response
10 in its entirety. The following bullet points more consistently summarize and highlight the
11 nature of the full response contained in this appendix:

- 12 • The test year provides the commission's staff with auditable data.
- 13 • For rate-making purposes, only just and reasonable expenses are allowed.
- 14 • The commission must have a basis for estimating future revenue requirements, which is
- 15 one of the most difficult problems in a rate case.
- 16 • A commission sets rates for the future, but has only past experience (expenses, revenues,
- 17 demand conditions) to use as a guide.
- 18 • Philosophically, the strict test year assumes the past relationship among revenues, costs,
- 19 and net investment during the test year will continue into the future. If these relationships
- 20 are not constant, the actual rate of return earned by a utility may be quite different from the
- 21 commission allowed rate.
- 22 • Commissions have adjusted test-year data for "known changes" that actually took place
- 23 during or after the test period (such as a new wage agreement that occurred toward the end
- 24 of the year).
- 25 • Due largely to inflation, a few commissions have modified the traditional historic test-year
- 26 approach by using a forward-looking test year (either a partial or a full forecast) or by
- 27 permitting pro forma expense and revenue adjustments.

28 [Surrebuttal Appendix SCC-1, Emphasis Added]

29 In my opinion, the test year portion of my direct testimony as well as my comments on page
30 68 are consistent with the spirit and intent of Surrebuttal Appendix SCC-1.

1 Q. At page 28, line 17, Mr. Redding states that out-of-period wage and salary adjustments qualify
2 as known and measurable changes. Do you agree?

3 A. There is no question that these increases are known and can be measured. But the real issue
4 is whether they should be recognized for regulatory purposes. Mr. Redding then proceeds to
5 argue that I do not know what a test year is all about, tries to split hairs about terminology and
6 points to his earlier quotes from the publications of others to support his contention.

7 Regulatory commissions have various test year approaches from which to choose in setting
8 rates:

- 9 • Historic test years may rely on an average or year-end approach.
10 • An end-of-period historic test year may be coupled with a fixed, or predetermined, post-test
11 year update period (e.g., 6 months beyond test year-end) within which all material known
12 and measurable changes (both price and volume) are eligible for consistent recognition.
13 • Forecast test years may be fully or partially projected, including a combination of historic
14 and forecast data.

15 The ultimate objective in selecting from this menu of test year options is the establishment of
16 rates for the future that will provide the utility with an opportunity to earn a reasonable return
17 on investment. Regardless of the test year approach, the various components of the ratemaking
18 equation must be reasonably balanced – an objective agreed to by Mr. Redding at rebuttal page
19 30. USWC has sought to reach out beyond the test year for only wage and salary increases, in
20 spite of the fact that similar increases occurred subsequent to the Company's original filing in
21 this proceeding (based on the 12 months ended June 1998) but USWC's update filing (using
22 the 12 months ended December 1999) resulted in "...a fairly limited change in the Company's
23 filed revenue deficiencies."

24 Q. Do you have any final comments on this portion of Mr. Redding's rebuttal testimony?

25 A. Yes. Beginning at page 29, line 7, Mr. Redding indicates that volumes can be adjusted outside
26 of a historic test period, but the test year becomes a forecasted test year which is contrary to

1 Arizona Commission tradition. Although I do not agree with this view of what constitutes a
2 forecast test year, there are two points which I believe are worthy of brief comment.

3 First, Mr. Redding quotes Dr. Alfred Kahn at page 5 of his rebuttal. One of Dr. Kahn's
4 observations was that even reliance on historic test year data "fully verifiable and verified,
5 graven in stone" is a form of projecting or estimating future costs. In this spirit, the recognition
6 of any test year or post-test year changes is a form of projection or forecast of future
7 conditions.

8 In response to ACC Staff Data Request No. 70-13, Mr. Redding states that his understanding
9 of a forecasted test year is a "year based on estimates of revenues, expenses and investment
10 rather than actual results." Even the recognition of a volume change one day beyond the
11 historic test year would result in a forecast test year, according to the response to this discovery
12 request. So, it would then appear that the Company has offered a forecast test year for the
13 Commission's consideration, contrary to Arizona tradition, because it is based on estimates
14 rather than actual costs.

15 Second, Mr. Redding quotes from several authors (pages 4 through 8 and page 28) on the
16 subject of test year selection and post-test year known and measurable changes. None of these
17 quotations state, suggest or imply that it is appropriate or permissible to reach out beyond the
18 historic test year for the piecemeal recognition of isolated changes to the exclusion of all other
19 known and measurable changes occurring during a similar time frame. Although the Staff has
20 not suggested such an approach, it appears that Mr. Redding has attempted to construct a
21 framework, relying on theories offered by others, to justify the Company's piecemeal approach
22 to the year 2000 wage and salary increases.

1 Q. At rebuttal pages 26 and 30, Mr. Redding refers to and concurs with a correction adjustment
2 proposed by RUCO witness Larkin. Were you aware of the need to correct an error in the
3 Company's update filing?

4 A. Yes. The existence of this error was confirmed in the Company's response to ACC Staff Data
5 Request No. UTI 46-4. Because of the Staff's proposal to eliminate USWC's entire post-test
6 year wage and salary adjustment, it was unnecessary for the Staff to correct the Company's
7 updated proforma adjustment for the August 2000 occupational increase. However, if the
8 Commission does not concur with the Staff's proposed out-of-period elimination adjustment,
9 it would be necessary and appropriate for the Commission to alternatively recognize this
10 correction of the Company's adjustment.

11 Q. Do you have any further information concerning the subject of changes occurring subsequent
12 to the test year?

13 A. Yes. On September 7, 2000, Qwest Communications International, Inc. announced that it will
14 cut 11,000 jobs by the end of 2001 in an effort to lower costs and streamline operations. Qwest
15 indicated that 4,500 of the jobs will be eliminated by the end of 2000, with the reduction of the
16 remaining 6,500 positions occurring in 2001. Qwest plans also include the elimination of
17 about 1,800 free-lance jobs by the end of 2001. According to information available at the time
18 this testimony was finalized, the Company raised its revenue projections for full-year 2000 and
19 2001.

20 So, as the landscape continues to change, so do the "costs" underlying the provision of Arizona
21 telecommunications service. While Arizona specific data is not available at this time, I can not
22 help but wonder if the Company will suggest a separate rider or tracker mechanism to capture
23 the Arizona portion of any resulting cost savings for the benefit of its regulated customers.

IMAGE ADVERTISING, OLYMPIC/SPORTS SPONSORSHIP

1 Q. Beginning at page 35, Mr. Redding's rebuttal testimony disagrees with your recommendation
2 to exclude image advertising and Olympic/ sports sponsorship costs from revenue requirement.
3 Specifically, he argues that: "image advertising supports the sale of all products...product-
4 specific advertising is incomplete without the complementary image advertising...as
5 competition grows and the public hears more brand names associated with
6 telecommunications, image advertising becomes increasingly important..." How do you
7 respond?

8 A. There are several points that merit consideration. I certainly understand the Company's
9 concern about the public hearing more names associated with telecommunications. After all,
10 during the test year, the Company spent almost [REDACTED] (Arizona intrastate) or about [REDACTED]
11 [REDACTED] (Total Arizona) to promote the U S WEST brand name. [See ACC Staff Adjustment
12 C-27.] Now, the Company is trying to promote the Qwest brand and image to the public.

13 During the 1999 test year, the Company also spent about [REDACTED] (Total Arizona) on
14 product advertising, which the Staff has not proposed to adjust or otherwise disallow. In order
15 to evaluate the effectiveness of its product advertising, the Company's Consumer Services
16 Group ("CSG") compiles campaign effectiveness reports to determine which product
17 campaigns receive future funding. According to Company responses to Staff discovery, these
18 campaign effectiveness reports are prepared to:

- 19 • evaluate the return of each campaign, compare returns from each campaign and to
- 20 determine which campaign with modifications will be implemented for the future, and
- 21 • allow CSG to establish a priority of campaigns to maximize limited advertising and
- 22 promotional budgets.

23 [ACC Staff Data Request Nos. UTI 71-3 and UTI 71-4]

24 Interestingly, the Company does not appear to analyze the "effectiveness" of promoting its
25 "image" or even consider such promotional costs in evaluating the success of its product

1 campaigns – even though the cost of image promotion was about 64% of the Company's
2 product advertising costs during 1999.

3 Q. At rebuttal pages 36 and 37, Mr. Redding quotes from a June 1999 publication that discusses
4 brand advertising. Have you reviewed this publication?

5 A. No. In response to ACC Staff Data Request No. UTI 71-6(a), the Company identified the
6 source as a copyrighted work, indicating that Qwest had no right to copy or reproduce the
7 word. Since the receipt of the Company's rebuttal testimony, I have had no time to locate,
8 purchase and review this document.

9 Q. At line 14 of page 36, the quote selected by Mr. Redding starts with the phrase:

10 "The market is hopelessly crowded. As a result: BRANDING IS MORE –NOT LESS
11 – IMPORTANT THAN EVER...."

12 Do you know what "market" the author is referring to?

13 A. No. Mr. Redding's selective quotations provide no clues as to whether this is a generic
14 statement that encompasses all business markets or is specific to telecommunications or some
15 other specific business segment. However, the response to ACC Staff Data Request No. UTI
16 71-6 leads me to believe that the reference to "the market" is a general one. According to Mr.
17 Redding, the cited publication was neither prepared for or at the request of the Company nor
18 prepared for or in the context of the telecommunications or utility industries.

19 Q. At page 35 of his rebuttal, Mr. Redding quotes from your testimony and indicates that the
20 Staff's disallowance is based on an incomplete chain of logic. How do you respond?

21 A. It is the Company that misses the point. As stated in my direct testimony, "USWC has not
22 demonstrated that promoting its imagery in a favorable light will influence growth in business
23 or residence access lines or customer decisions to purchase other discretionary services."

24 Regulatory agencies have been fairly consistent in disallowing the cost of non-product, image
25 or goodwill advertising for many years. In fact, the ACC disallowed USWC's image

1 advertising costs in the last rate case (Decision No. 58927, page 30, Docket No. E-1051-93-
2 183). More recently, the Public Service Commission of Utah addressed this issue and rejected
3 recovery of such costs in rates, as discussed in the following excerpt from the order in USWC's
4 most recent Utah rate proceeding:

5 To decide this issue we evaluate two propositions. The first concerns whether the
6 ratepayer-benefit test remains appropriate. If so, the second asks whether the Company
7 met its burden to show that ratepayers did benefit sufficiently to permit recovery of the
8 expense. Much of the Company's testimony argues that the ratepayer-benefit test no
9 longer is appropriate, but we are not persuaded. The testimony does not show why a
10 regulated firm's discretionary expenditure to enhance its corporate image should be
11 recovered from ratepayers, particularly when this Docket must be adjudged in the
12 traditional regulatory manner. We therefore reaffirm our previous ruling that corporate
13 or external advertising expense is not recoverable in rates. The Company has not
14 shown unambiguous ratepayer benefit. The argument that customers gain from
15 advertising calculated to make them feel better about the Company is not persuasive.
16 [UPSC Docket No. 97-0419-08, issued December 4, 1997]

17 Also, the Washington Utilities and Transportation Commission issued an order in a USWC
18 rate case (Docket No. UT-950200) in early 1996. The portion of the order addressing the
19 WUTC's findings on image advertising is reproduced below:

20 The Commission accepts the Commission Staff proposed adjustment to remove the
21 image advertising but not the allocated supervision. There appears to be little contest
22 as to the specifics of the advertisements in question. Corporate image advertising is
23 not shown to benefit the ratepayers. It is appropriately disallowed in telephone rate
24 cases.

25 [WUTC Docket No. UT-950200, Fifteenth Supplemental Order]

26 Nowhere in Mr. Redding's rebuttal testimony does the Company provide any quantification
27 of the effectiveness of or ratepayer benefits derived from its test year expenditures for image
28 advertising or related support for sports sponsorships.

1 Q. At rebuttal page 37, Mr. Redding indicates that your proposed disallowance of Olympic and
2 sports sponsorship costs contain the same logic error as these activities “are really extensions
3 of image advertising.” Do you agree?

4 A. I do agree with Mr. Redding that the Company’s Olympic and sports sponsorship activities are
5 “extensions of image advertising” – that is why ACC Staff Adjustment C-27 combined the
6 cost of these activities with image advertising in quantifying the Staff’s recommended
7 disallowance. However, I disagree with the “logic error” comment, for the reasons discussed
8 previously.

FCC DEREGULATED SERVICES

1 Q. Referring to page 45 of Mr. Redding's rebuttal testimony, he states that he agrees with the
2 financial end result of the Staff's two adjustments to include the FCC deregulated products in
3 revenue requirement, but not with your methodology. Have you reviewed that testimony?

4 A. Yes. It does appear that Mr. Redding and I agree on the "end result" but not the methodology.
5 So, I am uncertain whether there really is any revenue requirement issue, per se, for the
6 Commission to address.

7 Q. What two adjustments is Mr. Redding referring to?

8 A. There are actually three Staff adjustments related to the FCC deregulated services issue that
9 are discussed in my direct testimony. Beginning at page 77, I discuss ACC Staff Adjustment
10 C-17 which concerns the imputation of sufficient additional revenues to ensure that the
11 earnings deficiency associated with FCC deregulated services are not borne (or cross-
12 subsidized) by the remainder of USWC's Arizona customers subscribing to the Company's
13 intrastate regulated products and services.

14 At page 98, I also discuss ACC Staff Adjustments C-18 and B-7 which exclude USWC's
15 above-the-line recognition of the FCC Deregulated Services from the calculation of composite,
16 intrastate jurisdictional separation factors used in computing the intrastate share of the
17 individual adjustments posted to rate base and operating income.

18 It is these three adjustments that I believe Mr. Redding was intending to reference.

19 Q. Given the nature of Mr. Redding's rebuttal testimony on this matter, do you have any final
20 comments?

21 A. Yes. At pages 98-99 of my direct testimony, I discuss the rationale for ACC Staff Adjustments
22 B-7 and C-18 and state that the quantification of these adjustments assumed that the

1 Commission would adopt all adjustments proposed in the direct testimony of the Company and
2 the Staff. I go on to state that should the Commission ultimately reject or revise certain
3 adjustments, it would be necessary to recalculate these ACC Staff adjustments for consistency
4 with other Commission findings. Because of the magnitude of the Staff's proposed adjustment
5 for SOP 98-1 (internal-use software), it is imperative that these separation adjustments (i.e.,
6 ACC Staff Adjustments B-7 and C-18) be updated and revised to conform with the
7 Commission's final decisions on other ratemaking issues.

INCENTIVE COMPENSATION

1 Q. Beginning at page 3 of his rebuttal testimony, Mr. Grate discusses the proposals of Staff and
2 RUCO on the recoverability of incentive compensation costs. Have you reviewed this
3 testimony?

4 A. Yes. I have reviewed Mr. Grate's rebuttal testimony.

5 Q. Referring to page 5 of Mr. Grate's rebuttal testimony, he indicates that he does not oppose the
6 removal of the test year expenses associated with LTIP, because this plan has expired and been
7 replaced with a plan that will not generate any operating expense. Does this mean that Mr.
8 Grate is recommending that the test year costs of this plan be eliminated?

9 A. Initially, I interpreted this portion of Mr. Grate's rebuttal testimony as concurring with the
10 Staff's proposed elimination of the test year LTIP costs. However, the responses to ACC Staff
11 Data Request Nos. UTI 71-1 and UTI 71-8 appear to indicate otherwise. It seems that the
12 Company now believes that the test year incentive compensation costs are, in total, below the
13 level the Company believes will be ongoing. So, Mr. Grate did not recommend the elimination
14 of such costs. Based on this response, it appears that the Company is continuing to seek the
15 recovery of expenses it will no longer incur, which is inconsistent with Mr. Grate's testimony
16 on this issue in the pending New Mexico rate case.

17 Q. At rebuttal pages 5 through 7, Mr. Grate describes his opposition to the disallowances
18 recommended by Staff and RUCO. Do you have any general comments on this testimony?

19 A. Yes. As indicated in my response to Company Discovery Request USW 2-38, it is my opinion
20 that the ABP, STIP and LTIP incentive compensation plans do not result in costs that are
21 reasonable to be borne by the Company's Arizona ratepayers. While the rationale for my
22 opinions are presented in direct testimony, my conclusions are based on two basic premises
23 that are first introduced at page 39 of my direct testimony.

1 The incentive compensation plan costs that the Staff has recommended be disallowed are
2 primarily driven by corporate-wide financial results or surveys of customer perceptions of the
3 Company. In general terms, these corporate-wide goals and objectives do not address or define
4 specific service quality measures or performance expectations that are unique to the specific
5 work activity of the individual Company employee or common groups of employees, which
6 would most directly motivate employee work. The Company has not demonstrated the degree
7 to which the corporate-wide goals and objectives have motivated the broad base of employees
8 to perform at levels unlikely to be attained in the absence of such plans or that the plans have
9 resulted in achievements benefitting Arizona ratepayers that could not have been attained
10 without such plans.

11 Q. To what degree has the Company's incentive compensation plans improved financial
12 performance, cash flow, cost cutting initiatives, productivity or reduced capital costs that
13 would not have occurred in the absence of the incentive compensation plans?

14 A. I am unable to provide any definitive answer to that question. Through a series of discovery
15 responses following the receipt of the Company's rebuttal testimony on this issue, the
16 Company was requested to identify and quantify this very information. [See Company
17 responses to ACC Staff Data Request No. UTI 71-10 through UTI 71-14.] The Company
18 generally responded to these discovery requests stating: "Qwest does not possess the requested
19 information. Qwest could not develop the requested information without a special study." A
20 copy of these responses are provided as Surrebuttal Appendix SCC-2.

21 Q. In your opinion, should the Company have had this type of information readily available to
22 provide in response to the Staff discovery?

23 A. At page 8 of his rebuttal testimony, Mr. Grate states, in part: "Incentive compensation is used
24 to motivate employees to, among other things, improve financial performance and accomplish
25 strategic objectives." Although I did not necessarily expect information responsive to each of
26 these discovery requests, I am rather surprised that the Company was unable to provide any

1 data to demonstrate the tangible benefits it implies has been realized in Arizona from the
2 existence of these incentive programs – that would not have been otherwise achieved – as
3 support for the positions offered by Mr. Grate.

4 Q. At rebuttal page 20, Mr. Grate also states:

5 “However, the point and purpose of financial performance incentive compensation is
6 to motivate employees to achieve higher levels of financial performance than they
7 would be motivated to achieve absent the incentive. When employees respond to that
8 motivation and succeed in achieving better financial performance, employees,
9 shareholders and ratepayers all prosper together.”

10 Have any studies or analyses been prepared by, or for, the Company which demonstrate that
11 employees have responded to this “motivation” and achieved better financial performance than
12 could have been realized in the absence of the incentive compensation plans?

13 A. This question was posed to the Company through ACC Staff Data Request No. UTI 71-23.
14 The only information supplied by the Company was a two-page excerpt from the 2000 Hay
15 Compensation Information Services report (the “Hay Report”) on short-term incentive plans,
16 representing a compilation of survey information from 196 participating companies. This
17 information was not specific to USWC/Qwest and provided no direct evidence establishing a
18 cause and effect relationship between the specific financial objectives of the Company’s ABP
19 or STIP and improved financial results.

20 Although the narrative portion of the Company’s response to ACC Staff Data Request No. UTI
21 71-23 pointed to this Hay Report stating that 50% of the companies surveyed believed that
22 their short-term incentive plans were successful, the information supplied also indicated that
23 38% of the employees surveyed also believed that their companies’ incentive plans need
24 significant improvement.

25 Q. Referring to page 7 of Mr. Grate’s rebuttal testimony, he states that “...nothing justifies
26 disallowing the cost of the incentive compensation of that employee because the work the
27 employee does cannot be divided between work for incentive pay and work for all other forms

1 of compensation.” Have you suggested that the disallowance of the cost of the Company’s
2 incentive compensation plans can be justified on this type of basis?

3 A. No, I have not. Through the discovery process, the Company did ask me a related question
4 (i.e., Company Discovery Request USW 2-1. The full text of that question and my response
5 is reproduced as Surrebuttal Appendix SCC-4.

6 Q. At rebuttal pages 9-13, Mr. Grate introduces and discusses an illustration. At page 9, he
7 indicates that this illustration will “demonstrate mathematically the process by which the
8 benefit of improved financial performance inures to ratepayers.” Have you reviewed that
9 illustration?

10 A. Yes.

11 Q. At page 11 of his rebuttal testimony, Mr. Grate’s illustration assumes that the two utility
12 companies will end up paying exactly the same level of compensation to their respective
13 employees. Was it Mr. Grate’s intent to imply that USWC/ Qwest would have historically
14 paid its employees exactly the same level of compensation with or without the incentive
15 compensation plans?

16 A. No. According to the response to ACC Staff Data Request No. UTI 71-15, the purpose of this
17 presentation was purely for illustration purposes. As a result, it should not be interpreted as
18 a representation of the relative impact on the Company’s financial results – with or without
19 incentive compensation plans.

20 Q. In the context of this illustration, was it Mr. Grate’s intent to imply that the expenses of
21 USWC/ Qwest have always been lower historically as a direct result of its incentive
22 compensation plans?

23 A. No. This question was also addressed by the Company’s response to ACC Staff Data Request
24 No. UTI 71-16. Again, this presentation was purely for illustration purposes and should not

1 be considered indicative of the Company's operations – with or without incentive
2 compensation plans.

3 Q. Mr. Grate provides the following statement at page 22 of his rebuttal testimony:

4 “Qwest adopted the CVA as a measure of service quality because the Company
5 believes it directly measures customer satisfaction. Mr. Carver apparently believes that
6 as measures of service quality, surveys are inferior to direct measures. Placing his own
7 judgement about the best way to measure service quality above the judgement of
8 Qwest's management, Mr. Carver concludes that management use of surveys instead
9 of direct measures justifies disallowance. While Mr. Carver may prefer direct
10 measures of service quality, he has not shown why his own judgement should be
11 substituted for the judgement of Qwest's management in deciding how to measure
12 service quality for purposes of paying incentive compensation. Nor has he offered
13 substantial reasons that would demonstrate that service quality surveys are defective
14 as measures of service quality such that they justify a disallowance.”

15 Do you have any comments concerning Mr. Grate's rebuttal testimony on this subject?

16 A. Yes. I have not attempted to place my judgement above that of the Company's management,
17 as Mr. Grate suggests. Instead, I have reviewed the structure and objectives of the Company's
18 incentive plans and provided a recommendation to the Commission as to whether such costs
19 are reasonable and should be borne by the Company's regulated customers. It is the
20 Commission that will render a judgement on this issue, not I.

21 It is true that I believe that the CVA surveys are inferior to direct measures of service quality.
22 This opinion was not formed in a vacuum, without considering information unique to the
23 Company's survey process, as Mr. Grate seems to imply. According to the response to Data
24 Request No. UTI 26-4, the CVA was not initially developed for compensation purposes.
25 Instead, the CVA survey was to “help marketing and operations assess the company's relative
26 strengths and weaknesses versus competition to make changes based on customer input.” The
27 primary applications for the CVA included: marketing, strategy, operations improvements and
28 new product opportunity assessment.

1 The response to UTI 26-4 also stated that the CVA was introduced into compensation in 1998,
2 about two years after the initial CVA pilot program, in order to reflect:

- 3 1. direct customer feedback on overall performance using surveys, rather than internal
4 measures,
5 2. a comparison of the Company's performance versus competition,
6 3. the Company's relationship with its customers (service quality, price, product, brand) and
7 4. future market performance.

8 So, by integrating the CVA surveys into the incentive compensation structure, the Company
9 explicitly eliminated the more traditional measures of service quality from direct consideration
10 in exchange for customer and non-customer perceptions of the Company.

11 In this context, the Company's response to UTI 26-3 provided additional information of
12 interest. First, customers who do not have any interaction (i.e., service installations, changes
13 or billing questions) with the Company give the Company higher ratings than customers with
14 recent interactions. Second, those customers with recent service interaction rate the
15 Company's performance 5-10% lower. Third, nearly 40% of the Company's residential
16 customers do not have any service or billing interaction with the Company during a six-month
17 period. Fourth, brand or non-product advertising is viewed as one of the key drivers in creating
18 value and can significantly enhance brand reputation and impact CVA scores.

19 So, the CVA surveys reflect perceptions that can be significantly influenced by interaction with
20 the Company and by brand advertising campaigns. More "traditional" measures of service
21 quality address the Company's ability to get the service installation or repair done right the first
22 time and in a timely manner.

23 Q. At page 23 of his rebuttal, Mr. Grate states:

24 "Instead of complaining that the 1999 STIP and ABP did not pay out on three of the
25 five service quality measures, Staff should approve of the discipline with which Qwest
26 executed its incentive compensation plans. The total cost of incentive compensation

1 in the test year is substantially less than it would have been had all service quality
2 targets been met. This lower level of cost shows that Qwest's incentive compensation
3 plans have teeth. Instead of being grounds to disallow the service quality components,
4 this test year cost savings resulting from rigorous application of the standards in the
5 plans should be grounds for applauding the high standards of service quality the
6 Qwest's plans have set and enforced."

7 Do you care to respond?

8 A. Mr. Grate offers some interesting observations, but none that are particularly useful in
9 assessing the reasonableness of the service quality components of the Company's incentive
10 plans. As indicated in the response to ACC Staff Data Request No. UTI 71-25, even Mr. Grate
11 is not suggesting that it would have been reasonable or acceptable for the Company to apply
12 its own service quality standards in any way other than rigorously. Any other application
13 would have made a mockery of the process.

14 The perceptions of customers and non-customers throughout the Company's 14-State service
15 territory does not directly address the quality of the service actually rendered or delivered in
16 the State of Arizona. To the extent that Arizona customers are being asked to pay for the cost
17 of improving service quality, both the costs sought for recovery and the improvement in quality
18 should be based on Arizona operations – not costs or improvements in other State jurisdictions
19 much less Company-wide perceptions that may not directly translate into the provision of
20 higher quality Arizona service.

21 Q. Referring to the bottom page 23 and the top of page 24, Mr. Grate states in rebuttal:

22 "Mr. Carver's argument that the service quality component of the STIP and ABP
23 should be disallowed because the plans are too heavily weighted towards financial
24 criteria makes no sense. First, Mr. Carver offered no reason why the plans' service
25 quality components should be considered poisoned by the financial components.
26 Further, in an attempt to support his position, Mr. Carver measures the weighting of the
27 payout instead of the weighting of the plans. Because Qwest conscientiously enforced
28 the service quality standards in the plans they paid out relatively little for service
29 quality. Consequently, the 1999 plan payouts are weighted more heavily towards
30 financials than are the base line criteria in the plans themselves. Inexplicably, Mr.
31 Carver would have the Commission disallow the service quality components of the

1 STIP and ABP because Qwest applied them with rigor, and the result is a relatively low
2 payout for service quality in the test year.”

3 How do you respond?

4 A. It is true that the Company paid out less for the “service” components of the ABP and STIP
5 during 1999, because the objectives were not achieved. However, these plans are so heavily
6 weighted towards financial criteria that excellent financial results could largely overcome
7 unacceptable service quality in determining plan pay-outs.

8 Referring to pages 45 and 48 of my direct testimony, the STIP and ABP contain a 60%
9 weighting of corporate financial results. Ignoring the portions of the Individual Business Unit
10 objectives included in the ABP that are also reliant on financial results, employees participating
11 in the Company’s 1999 STIP and ABP could still achieve a near-target total bonus from
12 exceptional financial performance even if no bonus is achieved for service quality.

13 Q. How did you make this determination?

14 A. Confidential Attachment J of the response to ACC Staff Data Request No. UTI 60-11 indicated
15 that the maximum financial component pay-out for the 1999 STIP was [REDACTED]. Since 60% of
16 both the STIP and ABP are based on corporate financial measures, employees could achieve
17 a [REDACTED] pay-out (i.e., 60% financial weight times [REDACTED] maximum achievement) as compared
18 to a 100% pay-out if the targets for both the financial and service quality components were
19 met. Clearly, the weighting of the plan is an important factor in determining plan payouts.

20 Q. Mr. Grate also provides the following statement at page 24 of his rebuttal testimony:

21 “Finally, Mr. Carver observes but fails to acknowledge the significance of the fact that
22 company wide measures of service quality performance include Arizona among the 14
23 states measured. The weighting of the service quality results reflects the size of
24 Arizona’s operations in proportion to the size of the Company’s 14 state operations.
25 Likewise, the cost of these plans charged to Arizona operations reflects only the cost
26 of Arizona operations, not the cost of the Company’s total 14-state operation. Mr.
27 Carver may prefer that the Company operate 14 separate incentive compensation plans,
28 but his preference is hardly justification for disallowing their costs.”

1 Do you have any comments on this testimony?

2 A. Yes. The Company's Arizona test year operating expenses include an allocation of the cost
3 of the 1999 ABP and STIP incentive compensation plans. The costs of these plans are
4 considered in the development of the Company's overall revenue requirement and based on
5 corporate-wide targets and objectives, not Arizona specific targets and objectives. Both the
6 financial and service quality measures, not just service quality, are based on Company-wide
7 objectives. So, my concerns in this regard apply to both of these major elements of the ABP
8 and STIP.

9 Referring to the responses to ACC Staff Data Request Nos. UTI 18-26 and UTI 25-5, the
10 financial components of the Company's incentive plans are based on corporate results, not
11 State results. Although individual State operations are part of the total corporate operations,
12 the Company has indicated that individual State results are not separately tracked, are not
13 specifically considered and are not available.

14 Similarly, the response to Data Request No. UTI 18-27 indicated that the service quality
15 components of the incentive plans are also based on total Company measurements. More
16 specifically, item (c) of UTI 18-27 sought additional information comparing the relative service
17 quality achievements of the Arizona operations with the Company's consolidated operations.
18 The Company responded by simply stating: "No state results are used for the calculation."

19 Since Arizona only represents about 15% of the Company's consolidated operations, the
20 corporate-wide benefits alleged to result from these plans (e.g., improvements in financial
21 condition or perceptions of the Company) are not necessarily realized or realizable in Arizona
22 – because Arizona does not necessarily mirror the Company's consolidated operations.
23 However, the accounting allocation of the costs of these plans basically assumes that Arizona's
24 achievements and benefits are proportional.

1 Incentive plans are typically designed to motivate or improve employee performance. Because
2 the Company's Arizona operations are only about 15% of the consolidated operations, stellar
3 (or dismal) performance in Arizona would likely have limited impact on the consolidated
4 results under the incentive plans. As a consequence, Arizona employees could perceive
5 diminished incentives because the State's results are commingled with and diluted by those of
6 the other 13-State operations, either positively or negatively.

7
8 Based on the responses to discovery submitted during this proceeding, the Company has stated
9 that it does not maintain and has been unable to otherwise supply the information necessary
10 to compare Arizona's achievements relative to those of the total Company operations. Because
11 of the structure of the incentive plans and the cost allocation process employed, employee pay-
12 outs and the apportionment of costs to Arizona are not based on the financial or service
13 achievements attained in Arizona.

14 Q. Turning to Mr. Grate's rebuttal testimony beginning at page 28, he criticizes the Staff's
15 position on the business unit component of the ABP as follows:

16 "Mr. Carver, on the other hand, asserts he is unable to reach any conclusion about any
17 of the business unit goals because he lacks sufficient information to evaluate the
18 reasonableness of the business unit component of the ABP. He makes this allegation
19 despite the fact that Attachment H in the response to Data Request No. UTI 60-11
20 contains over 60 pages of information that cover each business unit that charged costs
21 to Arizona regulated operations. He asserts that in order to render an opinion, he must
22 have copies of communications by business units to employees about the business unit
23 goals and takes Qwest to task for not providing it. [Carver, p. 50, line 16 to page 51
24 line 2] Because he did not get what he wanted, he proposes to disallow all of the cost
25 of the business unit portion of the ABP. [Carver, p. 49, line 10 to page 51 line 2.]"

26 "Exhibits PG-2 and PG-3 respectively are the responses of which Mr. Carver
27 complains to Data Request No. UTI 53-02 and Data Request No. UTI 60-11. To the
28 best of my knowledge and belief, the responses provided to these data requests are true
29 and correct. They apparently provide enough detail for at least one witness hostile to
30 Qwest to render an opinion on them."

31 Do you care to respond?

1 A. Yes. Mr. Grate's rebuttal testimony only discusses part of the story underlying the business
2 unit component of the ABP. ACC Staff Data Request No. UTI 53-2 sought information
3 concerning the incentive compensation plans offered to U S WEST, Inc. personnel in 1999.
4 ACC Staff Data Request No. 60-11 was submitted to update the Company's earlier response
5 to ACC Staff Data Request No. 2-17 for information on the Company's incentive
6 compensation plans in effect during calendar year 1999. Mr. Grate fails to mention that the
7 responses to these two discovery requests were received by UTI on July 31, 2000 – days
8 before the filing of Staff's direct testimony.

9 Mr. Grate chose to attach the responses to ACC Staff Data Request Nos. UTI 53-2 and UTI 60-
10 11 to his rebuttal testimony as Rebuttal Exhibits PG-2 and PG-3, respectively. Although these
11 rebuttal exhibits are voluminous, the specific business unit information is largely limited to a
12 general listing of the performance targets, weighting factors and achieved results for the 1999
13 plan year. In some instances, this data provides an explanation of the business unit targets
14 while other business unit summaries only provide a "one line" listing of each objective.

15 As stated in my direct testimony, the Company has not supplied any specific documentation
16 of its communication of these objectives with the employees of each business unit. It is my
17 contention that this type of employee communication could be of value in assessing the linkage
18 of the business unit objectives with the work actually performed by the respective employees.
19 Without such data, it is impossible to determine whether such communications conveyed
20 meaningful information.

21 In order to further evaluate Mr. Grate's rebuttal testimony and follow-up the response to ACC
22 Staff Data Request No. UTI 60-11 (Rebuttal Exhibit PG-3), ACC Staff Data Request No. UTI
23 71-31 sought additional information concerning the general duties, responsibilities and
24 business objectives of each individual business unit. In my opinion, this information would
25 have provided another approach to assess the linkage of the ABP business unit objectives with

1 the overall duties and responsibilities of each business unit through which the Company's
2 employees report. Unfortunately, the Company response basically indicated that this
3 information was not centrally organized and was not available without a special study. The
4 response to ACC Staff Data Request No. UTI 7-31 is attached as Surrebuttal Appendix SCC-3.

5 Q. Are there any further comments associated with ACC Staff Data Request No. UTI 60-11
6 (Rebuttal Exhibit PG-3)?

7 A. Yes. This response contains duplicate information for 13 business units and data for 3 business
8 units that are not allocable or assignable to Arizona. In order to further convey the complexity
9 of the Company's incentive process, expenses for 11 business units do not originate at USWC,
10 but rather at affiliates of USWC whose costs are separately allocated to USWC.

11 Q. Do you have any final comments concerning Mr. Grate's rebuttal testimony on incentive
12 compensation?

13 A. Yes. On September 6, 2000, UTI received a copy of the complete 2000 Hay Compensation
14 survey discussed previously in response to ACC Staff Data Request No. UTI 72-1. One
15 portion of this report outlined the reasons that management and employees viewed the plans
16 (short-term and annual incentive plans) as needing improvement. These "reasons" are
17 reproduced below:

18 Among the reasons that **management** views plans *as needing improvement* are:

- 19 • inadequate "line of sight" to individual effort;
- 20 • payout/ pay insufficient;
- 21 • insufficient tie-in to individual performance;
- 22 • no differentiation between individuals (one size fits all);
- 23 • goals are unattainable (management trust issues);
- 24 • inadequate communication of plan objectives.

25 Among the reasons that **employees** view plans *as needing improvement* are:

- 26 • inadequate line of sight to individual effort;
- 27 • poor payout history or rewards too low to incent performance;
- 28 • plan design complicated, hard to understand, or inadequately communicated;

- 1 • lack of individual performance measures;
- 2 • perceptions of unfairness; and
- 3 • goals set are unrealistic, unattainable
- 4 [ACC Staff Data Request No. UTI 72-1]

5 According to the responses to several discovery requests received by UTI on September 1,
6 2000, the Company modified its ABP in January 1999 to incorporate objectives from the
7 Performance Bonus Plan. [See responses to ACC Staff Data Request Nos. UTI 71-37, UTI 71-
8 38 and UTI 71-39.] The following excerpt was obtained from these responses, which believe
9 supports my concern:

10 “Results adjustment for PBP” [as reflected in the confidential business unit information
11 supplied in Rebuttal Exhibit PG-3] refers to an adjustment made for Operations and
12 Technologies (O&T) managers on their quarterly Performance Bonus Plan (PBP).

13 O&T established the PBP for the majority of O&T managers in January 1999 as a
14 replacement for the Annual Bonus Plan (ABP). Budget for the PBP came from the
15 budget that would have otherwise been used for ABP. The aim of the PBP was to
16 focus O&T managers on improving key metrics like, for example, held orders and
17 missed commitments. . . .

18 The PBP for 1999 had 23 separate sub-plans: one for each of the 14 states and 9 others
19 for centralized and headquarters functions. The intent of having sub-plans was to
20 closely link managers to performance in jurisdictions and functions they served. . . .

21 As indicated at page 42 of my direct testimony, I have not proposed any disallowance of the
22 cost of the Performance Bonus Plan. Based on the above responses, several of the ABP
23 business unit objectives were modified in 1999 to tie-in with the PBP in order to “focus O&T
24 managers on improving key metrics like, for example, held orders and missed commitments.”
25 As a result of this information, I am continuing to review this recent discovery in conjunction
26 with the quantification set forth on ACC Staff Adjustment C-12 for possible further revision.
27 Any modifications will be supplied upon the completion of my review.

FAS87 PENSION ASSET

1 Q. Have you review the rebuttal testimony of Mr. Grate on the pension asset issue?

2 A. Yes, I have.

3 Q. On page 42 of his rebuttal, Mr. Grate testifies as follows:

4 "One of the fundamental accounting concepts that first year accounting students learn
5 is that all assets on a balance sheet must be funded by liabilities or equity. Because
6 Qwest cannot withdraw funding money from the Pension Trust for negative expense
7 and must, instead, debit the Pension Asset, the source of funding for the Pension Asset
8 is Qwest's investors who provide the money to fund debt and equity on Qwest's
9 books."

10 How do you respond to this statement?

11 A. This statement is curious. It is true that fundamental double-entry accounting is based on the
12 concept that debits equal credits. It is also true that, on the balance sheet, total assets must
13 equal the total of liabilities and equity. However, Mr. Grate's implication that only investors
14 supply debt and equity funds to support the pension asset is an oversimplification.

15 First, a substantial component of the "equity" recorded on the balance sheet is comprised of
16 retained earnings or cumulative income retained by the Company. If the negative pension
17 credits have not been flowed through to the benefit of ratepayers, those pension credits would
18 have increased the recorded income and, theoretically, resulted in higher retained earnings.

19 Second, Mr. Grate oversimplifies the accounting process. According to the response to ACC
20 Staff Data Request No. UTI 69-12, the average year-to-date Intrastate net investment at May
21 2000 used for the charts at page 9 of Mr. Redding's rebuttal is approximately \$1.63 billion.
22 However, the average Intrastate debt and equity capital from the same 1990 Report processor
23 supplied in response to ACC Data Request No. UTI 42-2 S1, Attachment H, is about of \$1.33
24 billion. Clearly, the debit side of the balance sheet equals the credit side of the balance sheet,
25 but the process of matching debits with credits is not a simple as that implied by Mr. Grate.

1 Q. Referring to page 40, Mr. Grate makes the following statement:

2 "As I explained in my testimony concerning incentive compensation, ratepayers always
3 benefit from decreases in costs reflected in regulated results of operations under cost
4 of service regulation. Pension Credits are negative costs that reduce revenue
5 requirement. Because every financial period is a test period (regardless of whether it
6 warrants a case before the Commission), every dollar recorded as Pension Credit has
7 a direct effect on revenue requirement. If revenue requirement changes enough, a rate
8 case and a rates change will be warranted. But whether or not a rate case occurs, and
9 regardless of the outcome of the case, ratepayers always benefit from the revenue
10 requirement dampening effect of Pension Credits."

11 Do you agree?

12 A. No. Mr. Grate posits that "ratepayers always benefit" from the Company's recording of
13 pension credits. It does not seem to matter that the pension credits may fluctuate significantly
14 from year-to-year, but ratepayers "always" benefit. If the Commission concurs with this
15 theory, then the "as recorded" approach to ratemaking should be symmetrical. If pension
16 credits "always" benefit ratepayers, would it also seem that positive expenses recorded by the
17 Company are always recovered when recorded "because every financial period is a test period
18 (regardless of whether it warrants a case before the Commission)". Interestingly, Mr. Redding
19 does not appear to concur, as he has proposed a rate rider or tracker to capture the annual
20 change in revenue requirement associated with the adoption with SOP 98-1.

21 Q. At rebuttal page 47, Mr. Grate states:

22 "Mr. Carver's testimony is careful to couch his advocacy concerning the reconciliation
23 requirement as his opinion. Mr. Carver's opinion-that the Company bears a burden of
24 demonstrating through a reconciliation that cumulative Pension Credits (the negative
25 pension expense) have been flowed through to its ratepayers-is not a generally accepted
26 ratemaking principle. If it were, then the other elements of ratebase that are created by
27 expense accruals (Accumulated Depreciation and Accumulated Deferred taxes) would
28 also be subject to the same burden that Mr. Carver would impose on the Pension Asset.
29 In fact, his position directly violates widely accepted ratemaking standards by
30 contravening the rule against retroactive ratemaking."

31 Do you care to comment on this testimony?

32 A. Yes. First, the Company has the initial responsibility to present a prima facie case to support
33 its requested rate relief. Once that case has been challenged, I believe that the burden does

1 shift to the Company to demonstrate that it has a right to include the pension asset in rate base
2 – a burden that I do not believe that the Company has carried in this proceeding.

3 Second, this Commission determines the “generally accepted ratemaking principles” that apply
4 in Arizona. In the last USWC rate case, this Commission concurred with my testimony on this
5 issue and excluded the pension asset from rate base – concluding that “the Company has not
6 presented sufficient evidence to clearly demonstrate that its shareholders have advanced the
7 excess pension amounts.” [ACC Decision No. 58927, page 5] As indicated at rebuttal page
8 53, Mr. Grate and I hold different opinions concerning the Commission’s past findings.

9 Third, Mr. Grate seems to be critical of the fact that I express my opinions in testimony. This
10 is a rather odd comment, particularly since a witness can only offer facts or opinions. I
11 suppose that Mr. Grate only likes the opinions that are set forth in his rebuttal testimony.

12 Q. At page 48 of Mr. Grate’s rebuttal, he states:

13 “Mr. Carver asserts that the widely accepted presumption that accrued expenses have
14 been recovered or flowed through in rates does not extend to Pension Asset. [Carver,
15 p. 132, line 24 through p. 133, line 2] However, he fails to offer any sound reason why
16 Pension Asset should not be subject to the same ratemaking principles that govern the
17 other elements of ratebase.”

18 On rebuttal pages 51-52, Mr. Grate further addresses your proposal using an analogy to
19 reconciling the balance of the accumulated depreciation reserve. How do you respond?

20 A. I do not agree that such a reconciliation would be necessary or appropriate with regard to
21 accumulated depreciation reserves, which I address briefly at pages 127-128 and 132-133 of
22 my direct testimony.

23 Costs incurred by a regulated entity are often presumed to be covered by existing rates,
24 regardless whether the cost of service study underlying said rates included a specific allowance
25 for those unique costs. In my opinion and experience, this presumption is based on the premise
26 that cost based utility rates are considered to be just and reasonable until such time as a moving

1 party carries its burden to establish that said rates are no longer just and reasonable (i.e., either
2 too high or too low).

3 Pension accounting changed dramatically with the adoption of FAS87. Prior to that change,
4 most companies (including USWC) based the amount of pension costs distributed between
5 expense and capital accounts on the level of contributions actually made to the pension fund.
6 Since the adoption of FAS87, USWC began recording negative pension costs that can and does
7 vary significantly from year to year. [See the table on page 118 of my direct testimony.]

8 Simply because the Company recorded negative pension costs, should regulators assume that
9 ratepayers have fully participated in and enjoyed lower rates as a direct result of the decrease
10 in recorded costs? If so, does that participation justify increasing rate base so that the utility
11 can earn a return on those "negative" costs through the pension asset? As discussed in direct
12 testimony, I do not believe that those questions should automatically be answered in the
13 affirmative.

14 The Company has sought to include a pension asset in rate base that arose from this accounting
15 change. In order to substantiate the inclusion of the pension asset in rate base, the Company
16 has argued that the associated pension credits have been flowed through to the benefit of
17 customers, thereby resulting in lower rates and investors being out-of-pocket for the
18 cumulative amount of the pension asset. In order to substantiate the claim for rate base
19 inclusion, particularly in light of the history associated with pension accounting, I have
20 proposed that the Company be required to clearly demonstrate that the cumulative pension
21 credits flowed through to ratepayers equal or exceed the cumulative pension asset proposed to
22 be included in rate base.

23 Certainly, regulated entities employ accrual accounting for purposes of recording depreciation
24 expense and maintaining the accumulated depreciation reserve. The depreciation accruals also

1 vary from year to year. However, unlike pension costs, the typical accounting for depreciation
2 does not result from a radical change in accounting, leading to an newly created asset that is
3 not directly "cash affecting" but which the company seeks to include in rate base.

4 Depreciation accrual rates change periodically and the level of depreciable plant generally
5 increases over time. However, the depreciation accrual process has existed for many years and
6 has not experienced the radical accounting change fostered by FAS87. Also, represcription
7 changes have often been accompanied by rate proceedings, comparable to the current
8 proceeding, unless the parties desired that the accrual rate change be implemented outside the
9 context of a rate proceeding.

10 I have not suggested or recommended that the recovery of each and every cost of service item
11 should be reconciled with past ratemaking decisions in establishing the cost of service for
12 future periods. However, if ratepayers are to be required to pay a return through the
13 ratemaking process on a pension asset balance (resulting from the recordation of negative
14 pension costs), I believe that regulators must be assured that ratepayers have fully enjoyed
15 reduced rates or somehow been provided the benefit of the negative costs resulting from the
16 adoption of FAS87. In this context, the change in pension accounting and the requested
17 inclusion of the pension asset in rate base requires a demonstration of ratepayer benefits, as
18 discussed previously; otherwise the pension asset should be excluded from rate base.

19 Q. Does this conclude your prepared surrebuttal testimony?

20 A. Yes.

REPRODUCTION OF THE RESPONSE TO USWC DISCOVERY
NEW MEXICO PUBLIC REGULATORY COMMISSION
DOCKET NO. UTILITY CASE 3008

USW 02-202: In reference to the Direct testimony of Mr. Carver at pg. 21 lines 7-18, please provide the authority, regulatory commission orders, textbook passages, accredited scholarly writings, legal cases and other materials supporting Mr. Carver's assertion that in order for the ratemaking equation to function properly the components of the equation, in part, "must be reasonably representative of ongoing levels". Please provide copies of the supporting material.

Response (Carver): Staff objects to the request because the request as posed is overly broad and unduly burdensome. Mr. Carver based the cited testimony on his prior regulatory experience, spanning a period of almost 23 years. The process of exhaustively searching UTI files and reproducing copies of related materials has not been done and would entail the commitment of unreasonable resources.

Specifically preserving and without waiving the stated objections, Staff provides the following response in the spirit of cooperation. See pages 3 through 5 of Mr. Carver's direct testimony as well as the responses to USW 1-19a and USW 1-160 for specific information concerning Mr. Carver's professional work experience in the regulatory field. Although reference material may be obtained and reviewed from time to time, Mr. Carver does not maintain a compendium of the specific information sought by the interrogatory. Nor did Mr. Carver specifically rely on any particular documents covered by the interrogatory in preparing the cited testimony. While the following excerpts on this subject appear in publications in the possession of Utilitech, it should be noted that Mr. Carver does not necessarily concur with the complete writings of the identified authors:

The Regulation of Public Utilities, p 196, Charles F. Phillips, Jr., July 1993.

"The company, with the concurrence of the commission or its staff, will generally select a 'test year,' frequently the latest twelve-month period for which complete data are available. The purposes of such a test year are as follows. In the first place, the commission's staff must audit the utility's books. For rate-making purposes, only just and reasonable expenses are allowed; only used and useful property (with certain exceptions) is permitted in the rate base. In the second place, the commission must have a basis for estimating future revenue requirements. This estimate is one of the most difficult problems in a rate case. A commission is setting rates for the future, but it has only past

experience (expenses, revenues, demand conditions) to use as a guide. 'Philosophically, the strict test year assumes the past relationship among revenues, costs, and net investment during the test year will continue into the future.' [footnote omitted] To the extent that these relationships are not constant, the actual rate of return earned by a utility may be quite different from the rate allowed by the commission. [footnote omitted] For many years, commissions have adjusted test-year data for 'known changes'; that is, a change that actually took place during or after the test period (such as a new wage agreement that occurred toward the end of the year). More recently, due largely to inflation, a few commissions have modified the traditional historic test-year approach by using a forward-looking test year (either a partial or a full forecast) [footnote omitted] or by permitting pro forma expense and revenue adjustments."

The Regulation of Public Utilities, p 407, Charles F. Phillips, Jr., July 1993.

"The commissions use several methods to deal with the problem of attrition (inflation). First, they may modify or replace the historic or past test-year method by (1) adjusting historic test-year data for 'known changes;' [footnote omitted] (2) using a 'year-end' rate base, rather than an 'average' rate base, for the test period; [footnote omitted] or (3) using a fully 'projected' or 'forecast' test-year approach. [footnote omitted] While a year-end or projected rate base is more representative of the future period for which rates are being set, a year-end rate base creates a mismatch unless revenues and expenses for the test year are adjusted to reflect year-end conditions."

Other publications include: Rate-Making Trends in the 1980's, Public Utilities Reports, Inc., Publishers, December 1988; Public Utility Accounting: Theory and Application, James E. Suelflow, 1979. In addition, Utilitech's resource files include numerous regulatory orders and decisions, some of which address the subject matter of this interrogatory. Further, Mr. Carver has been responsible for developing and presenting regulatory training programs for commission staff's and consumer groups, including the discussion of test year matching and consistency issues in the context of the ratemaking formula.

Arizona
Docket No. T-1051B-99-105
UTI 71-010

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: 010

Re: Grate Rebuttal, page 8 (Incentive Compensation). Mr. Grate states, in part, that: "Incentive compensation is used to motivate employees to, among other things, improve financial performance and accomplish strategic objectives." Please provide the following:

- a. Please identify and quantify the improvement in the Company's Arizona financial performance during the 1999 test year that would not have occurred in the absence of the incentive compensation plans.
- b. Referring to the response to item (a) above, please quantify the relative effect of Arizona's improved financial performance on the Company's consolidated financial results on which the 1999 incentive compensation plans are based.
- c. Please identify and quantify the specific strategic objectives that were accomplished in the Company's Arizona operations during the 1999 test year that would not have occurred in the absence of the incentive compensation plans.
- d. Referring to the response to item (c) above, please quantify the relative effect of Arizona's achievement of the identified strategic objectives on the Company's consolidated results on which the 1999 incentive compensation plans are based.
- e. Please provide a copy of all supporting documentation relied upon in responding to this request.

RESPONSE:

- a. Qwest does not possess the requested information. Qwest could not develop the requested information without a special study.
- b. See response to (a).
- c. Qwest does not possess the requested information. Qwest could not develop the requested information without a special study.
- d. See response to (c).
- e. See response to (a) and (c).

Phil Grate
Director - Regulatory Finance
1600 7th Ave.
Seattle, WA

Arizona
Docket No. T-1051B-99-105
UTI 71-011

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: 011

Re: Grate Rebuttal, page 8 (Incentive Compensation). Mr. Grate states, in part, that: "Employees cause improvements in financial performance by improving efficiency. They improve efficiency by innovating to cut costs and improve productivity. This improved productivity is embedded in the test year expenses." Please provide the following:

- a. Please identify and quantify the specific cost cutting innovations implemented in Arizona during the 1999 test year that would not have occurred in the absence of the incentive compensation plans.
- b. Referring to the response to item (a) above, please quantify the relative effect of Arizona's cost cutting innovations on the Company's consolidated costs on which the 1999 incentive compensation plans are based.
- c. Please identify and quantify the improvement in productivity achieved in the Company's Arizona operations during the 1999 test year that would not have occurred in the absence of the incentive compensation plans.
- d. Referring to the response to item (c) above, please quantify the relative effect of the improvement in Arizona's productivity on the Company's consolidated results on which the 1999 incentive compensation plans are based.
- e. Please provide a copy of all supporting documentation relied upon in responding to this request.

RESPONSE:

- a. Qwest does not possess the requested information. Qwest could not develop the requested information without a special study.
- b. See response to (a).
- c. Qwest does not possess the requested information. Qwest could not develop the requested information without a special study.
- d. See response to (c).
- e. See response to (a) and (c).

Phil Grate

Director - Regulatory Finance
1600 7th Ave.
Seattle, WA

Arizona
Docket No. T-1051B-99-105
UTI 71-012

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: 012

Re: Grate Rebuttal, page 8 (Incentive Compensation). Mr. Grate states, in part, that: "Improvement in financial performance is the yardstick that measures the tangible results of reduced costs and increased productivity. If financial performance does not improve, then the results have not been achieved. The calculus of the benefit is straightforward. If costs decrease, earnings increase. If cash is spent more wisely, cash flow improves. So financial improvement is the inevitable result of productivity, cost reduction and cash preservation improvements." Please provide the following:

- a. Please identify and quantify the specific cost decreases that resulted in earnings improvements in Arizona during the 1999 test year that would not have occurred in the absence of the incentive compensation plans.
- b. Referring to the response to item (a) above, please quantify the relative effect of Arizona's cost decreases on the Company's consolidated costs on which the 1999 incentive compensation plans are based.
- c. Please identify and quantify the specific changes in more wisely spending cash that improved cash flow in the Company's Arizona operations during the 1999 test year that would not have occurred in the absence of the incentive compensation plans.
- d. Referring to the response to item (c) above, please quantify the relative effect of the improvement in Arizona's cash flow expenditures on the Company's consolidated results on which the 1999 incentive compensation plans are based.
- e. Please provide a copy of all supporting documentation relied upon in responding to this request.

RESPONSE:

- a. Qwest does not possess the requested information. Qwest could not develop the requested information without a special study.
- b. See response to (a).
- c. Qwest does not possess the requested information. Qwest could not develop the requested information without a special study.

- d. See response to (c).
- e. See response to (a) and (c).

Phil Grate
Director - Regulatory Finance
1600 7th Ave.
Seattle, WA

Arizona
Docket No. T-1051B-99-105
UTI 71-013

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: 013

Re: Grate Rebuttal, pages 8-9 (Incentive Compensation). Mr. Grate states, in part, that: "The shareholder of a cost-of-service regulated business only gets the benefit of the financial improvement temporarily -- during the period of regulatory lag. Regulatory lag is the period between the time the benefit appears in results of operations and the time it becomes rate effecting, which is the period of one to two years that is required to conduct a rate proceeding (if one is required). When the financial improvement occurs, it becomes part of an historical test period and reduces revenue requirement derived from that test period. So the productivity improvements inure to the benefit of ratepayers in the form of higher test year earnings that lower revenue requirement and, thereby support lower rates for services." Please provide the following:

- a. Please identify and quantify the specific Arizona financial improvements that shareholders have benefitted from during the 1999 test year that would not have occurred in the absence of the incentive compensation plans.
- b. Please identify and quantify the cumulative improvements in Arizona's financial performance that have benefitted shareholders since the test year in the last Arizona rate case that would not have occurred in the absence of the incentive compensation plans.
- c. Please identify and quantify the specific reductions in Arizona revenue requirements during the 1999 test year that would not have occurred in the absence of the incentive compensation plans.
- d. Please provide a copy of all supporting documentation relied upon in responding to this request.

RESPONSE:

- a. Qwest does not possess the requested information. Qwest could not develop the requested information without a special study.
- b. Qwest does not possess the requested information. Qwest could not develop the requested information without a special study.
- c. Qwest does not possess the requested information. Qwest could not develop the requested information without a special study.
- d. See response to (a), (b) and (c).

Phil Grate
Director - Regulatory Finance
1600 7th Ave.
Seattle, WA

Arizona
Docket No. T-1051B-99-105
UTI 71-014

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: 014

Re: Grate Rebuttal, page 9 (Incentive Compensation). Mr. Grate states, in part, that: "Similarly, cash flow improvements benefit ratepayers by lowering the cost of capital because investors base the price they require for their capital on the cash flows of the enterprise." Please provide the following:

- a. Please identify and quantify the reduction in the cost of capital in the pending rate proceeding resulting from improvements in Arizona cash flow during the 1999 test year that would not have occurred in the absence of the incentive compensation plans.
- b. Please identify and quantify the reduction in the cost of capital in the pending rate proceeding resulting from improvements in the Company's consolidated cash flow during the 1999 test year that would not have occurred in the absence of the incentive compensation plans.
- c. Please identify and quantify the reduction in the cost of capital in the pending rate proceeding resulting from improvements in the Company's consolidated cash flow since the Company's last Arizona rate case that would not have occurred in the absence of the incentive compensation plans.
- d. Are improvements in cash flow the primary financial measure that investors rely upon in determining the price they require for their capital? Please explain.
- e. Please provide a copy of all supporting documentation relied upon in responding to this request.

RESPONSE:

- a. Qwest does not possess the requested information. Qwest could not develop the requested information without a special study.
- b. Qwest does not possess the requested information. Qwest could not develop the requested information without a special study.
- c. Qwest does not possess the requested information. Qwest could not develop the requested information without a special study.
- d. Risk, cash flows, and returns available on alternative investments are the primary drivers of investors' required return on capital investments.

"In the most general terms, the value of a firm (and, hence, the cost of capital) depends on the expectations regarding cash flow, the perceptions of risk, and the characteristic of the alternative investments that investors face. All three elements present formidable modeling problems. The cash flow expectations are those of investors who must assess, among other things, the future course of the business and the future action of regulators."

(Howard E. Thompson, *Regulatory Finance*, Boston, MA: Kluwer Academic Publishers, 1991, p. 207)

e. See response to (a), (b) and (c).

Phil Grate
Director - Regulatory Finance
1600 7th Ave.
Seattle, WA

Arizona
Docket No. T-1051B-99-105
UTI 71-031

INTERVENOR: Arizona Corporation Commission Staff (Utilitech)

REQUEST NO: 031

Re: Grate Rebuttal Exhibit PG-3 (Incentive Compensation). Referring to UTI 60-11, Attachment H, the Company provided a listing of weightings, targets and results for 49 (or 39) separate business units. Please provide the following:

- a. Please separately identify and describe the general duties, responsibilities and business objectives of each of the 49 (or 39) individual business units.
- b. For each of the 49 (or 39) individual business units, please explain the linkage between their respective duties/ responsibilities and the sub-component target objectives and weightings.

RESPONSE:

- a. Qwest has no central repository where the general duties, responsibilities and business objectives of each business unit is identified and described. The requested information could not be obtained without a special study.
- b. Qwest objects to this portion of request UTI 71-31 on the grounds that the request for "linkage" is vague. Notwithstanding this objection, Qwest responds that it has no central repository where the linkage between business units' respective duties/ responsibilities and the sub-component target objectives and weightings is explained. Each business unit is responsible for establishing target objectives and weightings that business unit senior managers deem appropriate for the circumstances of that particular business unit. The requested information could not be obtained without a special study.

Phil Grate
Director - Regulatory Finance
1600 7th Ave.
Seattle, WA

REPRODUCTION OF THE RESPONSE TO USWC DISCOVERY
ARIZONA CORPORATION COMMISSION
DOCKET NO. T-01051B-99-0105

USW 2-1. Please state all the reasons Mr. Carver believes that incentive compensation costs can be accorded a different recovery treatment in ratemaking than the costs of other forms of employee compensation. Specifically explain why the cost of an employee's incentive compensation could be disallowed while the other costs of compensating the same employee are not.

Response:

The Company incurs a multitude of costs, some employee related and others non-employee related, that are subject to review, evaluation, annualization and possibly even disallowance during the ratemaking process. The analysis and evaluation of these various categories of cost must consider the unique characteristics that drive the recognition and incurrence thereof. For example, the Company records both depreciation expense and amortization expense. Although both of these expense items represent forms of ratable recovery of an asset or deferred cost over time, the analysis, evaluation and annualization of depreciation is different from amortization and could lead to different ratemaking treatments.

Employee compensation also comes in different shapes and sizes. Employees typically receive base salaries and wages that are a function of time worked (hourly or monthly) and the rate of pay (hourly or monthly). For most employees, this form of compensation represents a substantial portion of their cash compensation. Employees are also typically eligible for vacation pay, sick leave, and other forms of paid absences that, within predefined parameters, allow employee absences without subjecting employees to reductions in pay. Certain employees may also be eligible for overtime or premium pay for time worked in excess of standard work requirements. Yet other employees may be eligible for incentive pay.

During a rate proceeding, each of these types or forms of compensation are reviewed and analyzed. Employee headcounts and periodic wage/salary increases are reviewed in the context of overall trends in regular or basic pay. When available, overtime/ premium hours and related dollars are also reviewed separately, as are overall levels of paid absences. In the context of a rate case using an EOP test year, these separate forms of

compensation and their unique drivers are individually analyzed and evaluated. As a result, it may be determined that annualization, normalization or disallowance adjustments are required to either increase or decrease recorded test year expense levels.

Incentive compensation is a unique form of employee compensation. Because incentive compensation is a discretionary form of compensation that requires conditions other than satisfactory work to precede or trigger any employee pay-out, the analysis of this compensation component properly includes a review and assessment of the provisions of such plans to determine whether the related test year costs are reasonable and should be borne by ratepayers. Although the individual employee has direct control over the quality and sufficiency of dispatching his/her day-to-day work activities in most situations, the individual employee has limited influence over the corporation's consolidated financial condition or survey results. Just because an individual employee may receive multiple forms of compensation (e.g., base pay, overtime pay, other paid time off as well as incentive pay), Mr. Carver does not believe that this "fact" is conclusive that each and every form of paid compensation the Company should automatically be deemed reasonable for recovery from ratepayers.

Please refer to Mr. Carver's direct testimony, beginning at page 39, for a discussion of the rationale for the Staff's proposal to exclude the cost of certain elements of the Company's incentive compensation plans from revenue requirement.

Witness: S. Carver
Prefiled Direct Testimony

US WEST COMMUNICATIONS
DOCKET NO. T-1051B-99-105
PROFORMA DEPRECIATION ANNUALIZATION
TEST YEAR ENDING DECEMBER 31, 1999
INTRASTATE (000's)

ACC Staff
Schedule C-15
Page 1 of 1
Revised

LINE NO.	DESCRIPTION	ACCOUNT	TOTAL STATE		%INTRASTATE	INTRASTATE		STAFF UPDATED TY ACCRUAL	DEPR RATES	ACC STAFF PROFORMA DEPR.	
			INVESTMENT	EXCHANGE SALE		12/31/99 INVESTMENT	EXCHANGE SALE			12/31/99 INVESTMENT	EXCHANGE SALE
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)		
1	Motor Vehicles	2112	\$67,008	\$2,204	0.7089	\$47,502	\$1,562	2.7%	1,283	42	
2	Spec Purpose Vehicles	2114	25	0	0.7089	18	0	13.4%	2	0	
3	Garage Work Equipment	2115	1,356	0	0.7089	961	0	18.1%	174	0	
4	Other Work Equipment	2116	22,416	423	0.7089	15,891	300	13.8%	2,193	41	
5	Buildings	2121	162,763	14,155	0.7089	115,383	10,034	2.9%	3,346	291	
6	Furniture	2122	1,704	7	0.7089	1,208	5	21.2%	256	1	
7	Office Equipment	2123.1	5,478	18	0.7089	3,883	13	19.2%	746	2	
8	Company Communication Equip	2123.2	1,467	83	0.7089	1,040	59	0.0%	0	0	
9	General Purpose Computers	2124	112,017	772	0.7089	79,409	547	4.5%	3,573	25	
10	Analog Switching Equip	2211	138,599	49	0.7996	110,824	39	(f)	18,000	0	
11	Digital Switching Equip	2212	819,226	51,289	0.7996	655,053	41,011	10.7%	70,091	4,388	
12	Operator Systems	2220	7,080	0	0.9178	6,498	0	7.4%	481	0	
13	Radio Systems	2231	35,323	14,698	0.6673	23,571	9,808	3.3%	778	324	
14	Circuit Equip										
15	Circuit DDS	2232	8,492	418	0.6673	5,667	279	0.0%	0	0	
16	Circuit Digital	2232	1,128,055	62,285	0.6673	752,751	41,563	8.9%	66,995	3,699	
17	Circuit Analog	2232	48,900	5,422	0.6673	32,631	3,618	1.5%	489	54	
18	Other Terminal Equip	2362	48,461	1,304	0.8273	40,092	1,079	7.1%	2,847	77	
19	Public Tel Terminal Equip	2351	17,969	0	1.0000	17,969	0	n/a	0	0	
20	Pole Lines	2411	46,617	9,703	0.7380	34,403	7,161	6.4%	2,202	458	
21	Aerial Cable Met	2421	164,522	32,219	0.7380	121,417	23,778	9.6%	11,656	2,283	
22	Aerial Cable Non-Met	2421	6,183	1,651	0.7380	4,563	1,218	9.3%	424	113	
23	Underground Cable Met	2422	348,312	11,073	0.7380	257,054	8,172	7.8%	20,050	637	
24	Underground Cable Non-Met	2422	86,984	2,944	0.7380	64,194	2,173	11.2%	7,190	243	
25	Buried Cable Met	2423	1,256,424	132,260	0.7380	927,241	97,608	11.1%	102,924	10,834	
26	Buried Cable Non-Met	2423	17,245	3,913	0.7380	12,727	2,888	6.7%	853	193	
27	Sub Cable Met	2424	3	3	0.7380	2	2	192.0%	4	4	
28	Sub Cable Non-Met	2424	0	0	0.7380	0	0	5.0%	0	0	
29	Intra Building Cable Met	2426	41,023	2,718	0.7380	30,275	2,006	3.2%	969	64	
30	Intra Building Cable Non-Met	2426	581	6	0.7380	429	4	9.5%	41	0	
31	Aerial Wire	2431	8,799	4,368	0.7380	6,494	3,224	17.4%	1,130	561	
32	Conduit Systems	2441	305,068	17,670	0.7380	225,140	13,040	2.3%	5,178	300	
33	Total		\$4,908,100	\$371,655		\$3,594,290	\$271,191	9.0%	\$323,874	\$24,637	
			(a)	(a)			(a)	(b)			

34 ACC Staff Proforma Intrastate Depreciation
35 Add: Offbook Depreciation Annualization (e)
36 Less: USWC's Proforma Depreciation Adjustment [P-03]
37 Less: Intrastate Per Book Depreciation [A/C 6561] (c)

38 ACC STAFF ADJUSTMENT TO RECOGNIZE THE TEST YEAR
UPDATE TO THE DEPRECIATION ACCRUAL RATES

Surrebuttal Appendix SCC-5
Page 1 of 1

FOOTNOTES:

(a) Source: USWC response to UTI 52-14.

(b) Source: ACC Staff witness Dunkel.

(c) Source: USWC response to UTI 46-06 for A/C 6561.

(d) Source: USWC response to UTI 55-2.

(e) Offbook Depreciation Annualization
12/99 ST AFUDC/ CRADS

12/99 AFUDC

Subtotal

Annualization Factor

Annualized OBK Amount

(f) 3-Year amortization of undepreciated amounts per ACC Staff Witness Dunkel

BEFORE THE
ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION)
OF US WEST COMMUNICATIONS, INC. A)
COLORADO CORPORATION, FOR A)
HEARING TO DETERMINE THE EARNINGS) DOCKET NO. T-01051B-99-0105
OF THE COMPANY FOR RATEMAKING)
PURPOSES, TO FIX A JUST AND)
REASONABLE RATE OF RETURN THEREON)
AND TO APPROVE RATE SCHEDULES)

SURREBUTTAL TESTIMONY AND SCHEDULES

OF

WILLIAM DUNKEL

ON BEHALF OF

THE STAFF OF THE ARIZONA CORPORATION COMMISSION

SEPTEMBER, 2000

**NOTICE: INFORMATION CLAIMED TO BE PROPRIETARY BY QWEST HAS BEEN
DELETED FROM THIS TESTIMONY. THROUGHOUT THIS TESTIMONY,
PROPRIETARY INFORMATION IS DESIGNATED AS FOLLOWS:**

****PROPRIETARY****

TABLE OF CONTENTS
SURREBUTTAL TESTIMONY OF
WILLIAM DUNKEL
DOCKET NO. T-01051B-99-0105

	<u>PAGE</u>
I. Introduction	1
II. Response to Mr. Wu	1
A. Modernization Accountability Credit	1
B. Future Retirements Are Used To Calculate The Current Depreciation Rates	4
C. Test Year Depreciation Expense	12
D. Mr. Wu Did Not Use The ACC Approved Depreciation Parameters For The Analog Switching Or Company Communications Accounts	13
E. Recommended Depreciation And Amortization	19
III. Response To Mr. Lee's Testimony On Behalf Of The Department Of Defense	20
IV. Rate Design	21
A. The Loop Is A Shared Facility	22
B. Qwest's Idea Of "Economically Efficient" Pricing Is To Shift The Burden Of Shared/Joint/Common Cost Recovery From Competitive Services Onto Non-Competitive Services	37
C. Competitive Zones	41
D. Higher Toll Revenues In Rural Areas Act To Offset The Higher Costs Of Shared Facilities In Rural Areas.	54
E. Directory Assistance	59
F. Privacy Listings	61
G. Contrary To Mr. Teitzel's Claims, TA96 Requires Affordable Universal Service For All Customers	62
H. Private Line	63

EXECUTIVE SUMMARY

Modernization Accountability Credit and Depreciation Issues

Below is a brief summary of some of the issues I address in this testimony with respect to Qwest's Rebuttal to my Direct Testimony of the Modernization Accountability Credit and other depreciation issues:

1. In the Depreciation proceeding, the Commissioners were interested in assuring in this case that Qwest would actually make the modernizations that were assumed in the depreciation rates the Commission approved for Qwest. Those depreciation rates were calculated assuming a very high rate of future modernization by Qwest in Arizona. When the rates from this case go into effect, customers will be paying approximately \$10 per line per month for intrastate depreciation expense. In his Rebuttal, Qwest's witness Mr. Wu proposes that Qwest should not be held accountable to actually make the modernizations that the Commission expects them to make. Mr. Wu's proposal is unacceptable and should be rejected. I recommend the Commission adopt the Modernization Accountability Credit presented in my Direct Depreciation testimony to properly hold Qwest accountable to make the modernizations that this Commission incorporated in the approved depreciation parameters.
2. In his Rebuttal, Mr. Wu claims that future retirements are not used in the calculation of depreciation rates, which is false. Future retirements are used to calculate the "remaining life" (life which remains until retirement), which is a key part of the depreciation calculation.
3. Mr. Wu's claim that the percent of the pairs in the metallic cables that is actually being used is declining is false. ARMIS data shows the number of metallic pairs working, and the percent working is increasing.
4. Mr. Wu's claim that proper depreciation rates should be calculated over a life that is shorter than the "service life" violates the applicable ACC and USOA depreciation standards.
5. Mr. Wu proposes to arbitrarily assign all of the recovery of a large reserve deficiency for Analog Switching to just a one year period. This proposal is arbitrary, inappropriate, and overstates the claimed expense during that one year period, when these costs were not actually all incurred in that one year period. A much more appropriate method of recovering this unusually large reserve deficiency would be to amortize these costs over a several year period. An \$18,000,000 per year amortization will amortize the deficiency over approximately three years. This is a commonly accepted recovery procedure, and

spreads the burden of recovery more evenly over a period longer than just one year.

6. Mr. Wu's Rebuttal to my Direct testimony raised certain issues pertaining to how I "rounded" certain numbers and how I "composited" certain accounts. These issues make very little difference in the calculation of the depreciation accruals. However, in this testimony I resolve Mr. Wu's concerns by adopting Mr. Wu's preferred "rounding" and "compositing" methods, therefore these are no longer items of dispute between Staff and Qwest.
7. For the Company Communications Equipment account, the depreciation rates that Mr. Wu proposes in his Direct and Rebuttal testimonies, were not calculated using the Commission approved "projection life" parameters. The depreciation rate that Qwest is currently booking also does not apply the Commission-approved "projection life" parameter to this Account.
8. I recommend that the depreciation rates and amortization shown on Schedule WDA-25 be adopted. These rates are proper, are calculated by applying the Commission-approved depreciation parameters to the test year (12/31/99) reserve and investment "per book" figures. For Analog Switching Equipment, this proposal includes a reasonable amortization of the deficiency of \$18 million per year, which will amortize the deficiency over an approximate three year period.

Rate Design

Below is a brief summary of some of the issues I address in this testimony with respect to Qwest's Rebuttal to my Direct Testimony on Rate design issues:

1. Qwest's witness Dr. Taylor presents a number of flawed arguments in an attempt to convince the Commission that the loop costs are direct costs caused solely by the provision of basic exchange service, not shared facilities as I testified in my Direct Testimony. However, Dr. Taylor's failure to properly identify the loop costs as shared facilities stems from a mis-application of TSLRIC principles due to his apparent failure to recognize how the telecommunications network is engineered. The telecommunications network is engineered such that a whole family of services depends upon and is supported by the loop facilities. Without the loop facilities, the provision of toll, switched access, vertical services and basic exchange service would not be physically possible. Since all of these services require the loop facilities, it is an undeniable physical and engineering fact that the loop is a facility that is shared by a whole family of services, not just one of the services that is supported by the loop facilities.
2. In another state, Dr. Taylor specifically admitted that a loop facility would be required to provide toll service, even if basic exchange service were not provided. Therefore, Dr. Taylor is unable to support his claim that the loop costs are caused solely by basic exchange service.

3. Dr. Taylor refers to "economics literature" that Dr. Taylor claims discredits my view of the loop as a shared facility. However, The "economics literature" that Dr. Taylor refers to were two articles that were authored by Dr. Taylor or other individuals who are well known for their work as witnesses who testify of behalf of telephone companies. All authors of the two articles he referenced are currently or were associated with Dr. Taylor's firm. In contrast, I have supported my view of the loop facilities as shared facilities, by citing numerous regulatory authorities, including the Supreme Court, the FCC, the Joint Board, the orders of the commissions in a number of other states and NARUC.
4. In yet another flawed attempt to justify his position, Dr. Taylor alleges that long distance carriers (IXCs) get to use the loop facilities owned by the LECs for free, therefore the IXCs are able to provide toll service and avoid the cost of the loops. However, Dr. Taylor's claim is not true. Dr. Taylor fails to recognize the fact that the IXCs must pay Qwest for sharing the common lines (loops) that Qwest owns when the IXCs pay Qwest an intrastate Carrier Common Line Charge (CCLC) to share the loop facilities owned by Qwest. The CCLC is the switched access charge by which Qwest recovers a portion of the loop facilities costs from the IXCs.
5. Dr. Taylor argues that since the loop facilities are non-traffic sensitive, this somehow means that basic exchange service must recover all of the loop facility costs. However, even if the loop facilities costs are non-traffic sensitive, this does not in any way implicate basic exchange service as the sole cause of the loop facility costs. "Fixed" charges could be billed to IXCs just as easily as to end users. The "fixed" costs are a part of almost any business, just like "rent" might be considered a "fixed" cost of a fast food restaurant.
6. When calculating the costs of intrastate services, Mr. Thompson proposes to ignore the fact that 25% of the loop facilities costs are allocated to the interstate jurisdiction and recovered in intrastate rates. However, if Mr. Thompson's proposal were adopted, and rates for intrastate services were based upon the unseparated costs, the result would be a double recovery of the interstate portion of the loop facility costs. This inappropriate proposal should be rejected.
7. In my Direct, I testified that special access bypass of switched access was economical for only high users. In his Rebuttal to this testimony, Mr. McIntyre's provided an invalid analysis that fails to consider that those customers subscribing to a special access line would pay toll charges in addition to the charge for the special access line.
8. In his Rebuttal, Mr. Thompson attempted to downplay the significance of the numerous State Commission Orders that I referenced that specifically found the loop to be a shared facility, by pointing out that most of these orders were issued

prior to the TA96. However, one of the Commission orders I referenced was that of the Indiana Utility Regulatory Commission (IURC), which is dated October 28, 1998. Not surprisingly, Mr. Thompson fails to mention that this Order specifically dealt with the TA96, and specifically found that assigning 100% of the loop cost to one service would violate Section 254(k) of TA96.

9. Dr. Taylor recommends that markups above TSLRIC for services should be determined using "Ramsey Pricing" principles. However, this form of pricing has been regularly rejected by regulatory authorities. Ramsey pricing means charging more where the company has monopoly power and less where it does not. This is an abuse of monopoly power. One of the primary reasons regulation of monopoly services exists is to prevent the companies from abusing that monopoly power. This proposal should be rejected.
10. In his Rebuttal, Mr. Teitzel's claimed that Qwest's proposed "competitive zone" is consistent with the Commission's Rules, however it is not. The information that the Commission's rules require would not be required to classify a wire center as a "competitive zone." Under Qwest's proposal, Qwest would not be required to show any indications of market power, provide the estimated market share, provide a description of the general economic conditions in the relevant market that make the service competitive, or provide most of the other information that are properly required by the current Commission rules in order to determine if effective competition exists.
11. Mr. Teitzel's Rebuttal provides an example that purportedly shows "extremely more prevalent" competition in the Chandler-Main wire center than in the Bisbee wire center. However, it does not. Mr. Teitzel's example merely demonstrates that there is a tiny amount of resale competition in both of these two wire centers at this time.
12. In its Rebuttal, Qwest is claiming that it has price flexibility in Oregon. However, in Oregon, rates for competitive zone services cannot be higher than the rates that were in effect when the competitive zones were established, unless authorized by the Commission. In Arizona, Qwest generally proposes that the ceiling be double the existing rate.
13. In his Rebuttal, Mr. Teitzel claims that Qwest will continue to adhere to the Commission's rules for pricing competitive services if the "competitive zone" proposal is adopted. However, the Qwest "competitive zone" proposal would allow Qwest to price competitive services below the TSLRIC of providing the service, which is contrary to the ACC's competitive service pricing rule.
14. Qwest's Rebuttal attempts to address concern surrounding the Qwest proposal to establish maximum rates in "competitive zones" at "double" the current rates by pledging that it is not Qwest's "intention" to double the rates. However, if the understanding is that Qwest does not "intend" to double the rates, then the logical

way to assure that intention is followed is to set the rules so that they cannot double the rates.

15. Dr. Taylor responded to my direct testimony pertaining to the HHI by providing a specific example of the HHI for the interstate toll market when AT&T was declared a non-dominant carrier by the FCC. Thanks to the estimate provided by Dr. Taylor, we now know that the market concentration in the wire centers which Qwest proposes be immediately declared as "competitive zones" is nearly **
** the market concentration in the interstate long distance market when the FCC declared AT&T as a non-dominant carrier.
16. Mr. Teitzel claimed that competitors would be driven away from rural areas unless the Zone Increment Charges are increased in response to UNE loop rate de-averaging. However, his arguments are based on the faulty premise that the loop cost (as identified by the UNE loop rates) is directly a cost of only basic exchange service. In reality, the UNE loop costs are not directly related to just the basic exchange service rates, but are related to the entire family of services that share the loop facilities. In addition, rural customers generally have a more limited local calling area than do urban customers, and therefore pay toll rates for calls which an urban customer pays local rates. Since competitors have the opportunity to receive higher toll/switched access revenues for rural customers compared to urban customers, this offsets part of a higher UNE loop rate in rural areas.
17. Mr. Teitzel claims that I stated that Qwest can expect an increase in toll revenues as a result of its proposed toll rate reductions. However, this is not my testimony in this proceeding. My testimony simply pointed out the inconsistency between Qwest's claim and Qwest's revenue impact calculation. Qwest claims that it will be better off in the market if it reduces toll rates, because the lower rates would be more attractive to customers. However, Qwest's revenue impact calculation assumes it would be worse off if toll rates are reduced, because the revenue impact calculation shows a net revenue reduction, as a result of reducing the toll rates. Qwest has the ability to change its toll prices itself, since the Commission has designated toll as a "competitive" service. (a) If the Company chooses to keep the current rates, that is their choice. In that event, no revenue support should be extracted from the rates of other services. (b) If Qwest chooses to reduce its rates, that is an executive decision. If that is a good decision and enough customers are attracted by the lower rates to offset the lower rates, then no revenues need to be recovered from other customers. On the other hand, if that is a poor executive decision which results in a net reduction in the Company's toll revenues, then the customers of other services are not responsible for a poor executive decision. Under the "competitive" pricing flexibility that has been given the Company, rates for other services should not be increased in order to support changes in "competitive" prices.

18. In my Direct testimony, I indicated that Qwest had miscalculated the revenue impact for Directory Assistance. In his Rebuttal, Mr. Teitzel claims that this calculation is not in error. However, in this testimony, I demonstrate that in its Directory Assistance revenue impact calculation, Qwest mishandled the effect of the temporary surcharge. In effect, Qwest calculated a revenue impact of going from a 59 cent Directory Assistance charge (with a one call allowance), to an 85 cent charge (with no call allowance). However, the revenue impact of the current proposal is higher, because the current proposal is to go from the current 47 cent Directory Assistance charge (with a one call allowance), to an 85 cent charge (with no call allowance).
19. Mr. Teitzel argues that the Qwest proposal to increase privacy listings rates because these services are "discretionary". However, since the customers of these services are sometimes victims of harassment, these customers are actually in a captive market, where they must pay whatever rates Qwest charges them in order to maintain their safety.

1 I. INTRODUCTION

2

3 Q. ARE YOU THE SAME WILLIAM DUNKEL WHO PREVIOUSLY PREFILED TESTIMONY

4 IN THIS PROCEEDING?

5 A. Yes.¹

6

7 Q. WHAT IS THE PRIMARY PURPOSE OF THIS REBUTTAL TESTIMONY?

8 A. The primary purpose of this Rebuttal testimony is to respond to the Rebuttal testimonies of

9 Qwest² filed on or about August 21, 2000, and the Direct testimonies of parties who filed their

10 testimonies on or about July 25, 2000 through August 9, 2000.

11

12 II. RESPONSE TO MR. WU

13

14 A. MODERNIZATION ACCOUNTABILITY CREDIT

15

16 Q. SHOULD QWEST BE HELD ACCOUNTABLE FOR THE MODERNIZATION THAT IS

17 ASSUMED IN THE ACC APPROVED DEPRECIATION PARAMETERS?

18 A. Yes. Discussions during the Open Meeting on this issue supported this proposition.³ Customers

19 will be paying almost \$10 per month per line to Qwest to cover the calculated intrastate

20 depreciation expense. The depreciation expense is so high only because the depreciation

¹ Throughout this testimony, my "Direct testimony on Modernization, Depreciation, and RCNLD Issues" will be referred to as my Direct Depreciation testimony. My "Direct Testimony on Rate Design Issues" will be referred to as my Direct Rate Design testimony.

² Throughout this testimony, the names "Qwest" and "USWC" are used interchangeably.

³ Tr. 46-47, 52, April 25, 2000 Open Meeting.

1 parameters adopted by the ACC assume a very rapid rate of future modernization by Qwest.

2 Under Mr. Wu's proposal, the Company would receive that \$10 per month per line from the
3 customers that was based on specific future replacement expectations, but Qwest would in no
4 way be accountable for actually delivering the future modernization that was assumed in the
5 calculation of those depreciation rates. Mr. Wu's proposal is clearly unbalanced.

6
7 It would not be fair to the customers to allow Qwest to collect \$324 million per year⁴ from them
8 based on specific expected future equipment replacements by Qwest, without assuring those
9 expected replacements actually occurred. Qwest wants to take the money, but not be responsible
10 to make the expected replacements.

11
12 Q. HOW DID MR. WU RESPOND TO YOUR PROPOSED MODERNIZATION CREDIT?

13 A. Mr. Wu stated:

14 There is no need for another program to address the adequacy of modernization.⁵
15

16 Mr. Wu argues that Qwest should not be accountable to actually implement the modernization
17 that was assumed in the ACC approved depreciation parameters.

18
19 Q. WOULD MR. WU'S PROPOSAL HARM THE ARIZONA ECONOMY?

20 A. Yes. Using the ACC approved depreciation parameters, Qwest will be collecting almost \$10 per
21 line per month from customers to cover the intrastate depreciation expense. This is \$324 million

⁴ Column N of Schedule WDA-25.

⁵ Page 11, Lines 6-7, Wu Rebuttal.

1 per year.⁶ If Qwest takes the money from the Arizona customers, but does not make the
2 expected modernizations in Arizona, that will harm the Arizona economy. When Qwest collects
3 this \$10 per month per line from the customers, that takes the money out of circulation in
4 Arizona. The customers cannot spend that \$10 for other services or goods in Arizona. If Qwest
5 collects the money in Arizona and then diverts it to other states, that will harm the Arizona
6 economy. Only if Qwest makes the expected replacements in Arizona will that money remain in
7 Arizona.⁷

8
9 The Commission should reject Mr. Wu's position that Qwest should not be accountable for
10 making the expected replacements in Arizona that are incorporated in the Commission-approved
11 depreciation rates.

12
13 Q. MR. WU STATES THAT THE MODERNIZATION REQUIREMENTS INCORPORATED IN
14 THE QWEST AND USWC MERGER SHOULD BE SUFFICIENT.⁸ DO THE
15 MODERNIZATION REQUIREMENTS INCORPORATED IN THE MERGER REFLECT
16 THE ACCELERATED MODERNIZATION THAT WAS ASSUMED IN THE
17 DEPRECIATION PROCEEDING?

18 A. Absolutely not. The merger agreement required Qwest to only invest in the years 2000 and 2001
19 at a level equal to the historic investment levels.

⁶ Column N of Schedule WDA-25.

⁷ Hopefully, along with some new money from shareholders. There is no requirement that the amount spent for new equipment equal the investment retired. With inflation and other effects, that frequently may not be the case.

⁸ Page 11, lines 1-7, Wu Rebuttal.

1 We can see no reason why applicant would not be willing to commit to an investment
2 level for the years 2000 and 2001 at least at the amount of the historic average of \$402
3 billion.⁹
4

5 The modernization requirement incorporated in the merger agreement did not anticipate any
6 accelerated modernization, but simply required that for the next two years, the modernization
7 continue at a level similar to what had occurred in the past.
8

9 The Commission-approved depreciation parameters assume much more rapid modernization will
10 occur in the future than has been occurring in the past by Qwest in Arizona. This accelerated
11 modernization is not reflected in the merger agreement, as previously discussed.
12

13 **B. FUTURE RETIREMENTS ARE USED TO CALCULATE THE CURRENT**
14 **DEPRECIATION RATES**
15

16 Q. IN THE CALCULATION OF THE DEPRECIATION EXPENSE, MR. WU STATES,

17 When retirements ultimately occur is not significant in this analysis.¹⁰
18

19 ARE FUTURE EXPECTED RETIREMENTS SIGNIFICANTLY USED IN CALCULATING
20 THE DEPRECIATION RATES?

21 A. Yes. Mr. Wu either misunderstands or has misstated one of the basic factors that is used to
22 calculate depreciation rates. A specific future expected retirement pattern is incorporated in
23 calculating depreciation rates. Based upon those future retirement assumptions, an average
24 "remaining life" is calculated. The average remaining life is the average number of years which

⁹ Page 13, ACC Decision 62672. The ACC did require that a specific portion of this be directed to upgrade rural exchanges.

¹⁰ Mr. Wu's response to Request WDA 34-005. Similar statements also appear on pages 6 and 7 of Mr. Wu's Rebuttal.

1 remain before the existing investments are expected to retire. This "remaining life" is one of the
2 factors that is directly used in the calculation of the depreciation rate, as is shown below:

$$\text{Remaining Life Rate (\%)} = \frac{(100\% - \text{present depreciation reserve \%} - \text{Future net salvage\%})}{\text{Remaining Life (Years)}}$$

6 The "remaining life" is how many years are left before the investments retire.

8 Mr. Wu's claim that when the retirements are expected to occur is not "significant in this
9 analysis", is simply a misrepresentation of the basic principles of calculating depreciation rates.

11 Q. DO THE DEPRECIATION PARAMETERS THAT THE COMMISSION ADOPTED IN THE
12 DEPRECIATION PROCEEDING INCLUDE A SPECIFIC PROJECTION OF FUTURE
13 RETIREMENTS?

14 A. Yes. For example, attached as Schedule WDA-25 is the projection life table that was used in the
15 calculation of the remaining life for Aerial Cable-Metallic, Account 2421. As can be seen,
16 Column C includes specific different amounts of retirement each year. Achieving the ACC
17 selected projection life and curve shape which are shown at the top of that page requires that
18 specific retirement pattern. Column H calculates the ELG average remaining life for each
19 vintage. That calculation is directly based upon the future expected retirements that are shown in
20 Column C. The retirement pattern and remaining life by vintage shown on this sheet are used to
21 calculate any remaining life that uses the listed projection life and curve shape. This same
22 retirement pattern was used in calculating the depreciation lives based on 1/1/97 investments,
23 and the same pattern was also used in calculating the depreciation rates based on 12/31/99
24 investments. The average remaining life that is used in the depreciation calculation is calculated

1 by applying the remaining life from the above-referenced Column H to the dollar amount of
2 investment that exists for each age.
3

4 Q. CAN YOU DEMONSTRATE THAT THE AVERAGE REMAINING LIVES THAT MR. WU
5 HAS CALCULATED ARE IN FACT BASED UPON THE CALCULATIONS THAT
6 INCORPORATE A SPECIFIC ASSUMED FUTURE RETIREMENT PATTERN?

7 A. Yes. On Rebuttal Exhibit KDW-2, Mr. Wu calculates a depreciation rate using a remaining life
8 of 5.1 years for this Account. Page 4 of Schedule WDA-26 contains a discovery response which
9 shows the calculation of the 5.1 years remaining life that Mr. Wu used.¹¹ As can be seen on page
10 3, Column E of that Schedule, the remaining life that is being used for each vintage in this
11 calculation is the exact same remaining lives that came from Column H of Schedule WDA-25.
12 As previously discussed, those remaining lives are based upon a specific anticipated retirement
13 patterns for each year in the future.

14
15 Mr. Wu's claim that the future retirements are not incorporated in the depreciation parameters
16 and expense calculated is simply incorrect. As shown on Schedules WDA-25 and WDA-26, the
17 calculation of that remaining life involves a specific projection of how much investment will
18 retire each year in the future.
19

¹¹ I added the box to this figure on this Schedule for emphasis.

1 Q. MR. WU ALLEGES THAT "AN ASSET SHOULD BE FULLY DEPRECIATED PRIOR TO
2 ITS PHYSICAL RETIREMENT."¹² (EMPHASIS ADDED) IS THAT THE PROPER
3 DEPRECIATION STANDARD?

4 A. No. The requirements that apply to this proceeding are that the depreciation rates should be
5 designed so that the asset is fully depreciated at the time of its retirement. To intentionally
6 design the rates so that the investment would be fully depreciated significantly before or after the
7 time of its expected retirement is to miscalculate the depreciation rates.

8

9 The depreciation definition and requirements set forth in Section R14-2-02 "Treatment of
10 Depreciation" for Fixed Utilities of the Arizona Administrative Code apply. The ACC has also
11 adopted the Uniform System of Accounts (USOA) for Telecommunications Companies (FCC
12 Part 32, 47 CFR, Ch. 1) apply. The Arizona Administrative Code and the USOA specifically
13 require that the depreciation expense be distributed "in a rational and systematic manner", or on a
14 "straight-line method" over the "service life." The "service life" is the life from the time the
15 investment is placed in "plant in service" to the time it is retired from service and the books of
16 the company.¹³

17

18 The Arizona Administrative Code, Section R-14-2-102(A)(3) states:

19

20 'Depreciation' means an accounting process that will permit the recovery of the original
21 cost of an asset less its net salvage over the service life. (emphasis added)

22 Section R14-2-102(B)(3) requires:

¹² Page 10, line 11, Wu Rebuttal.

¹³ In "remaining life" depreciation, the average life remaining until the investment is expected to be retired from the books (ending its "service life") is utilized.

1
2 The cost of depreciable plant adjusted for net salvage shall be distributed in a rational and
3 systematic manner over the estimated service life of such plant. (Emphasis added)

4 Section R14-2-102(A)(9) states:

5
6 'Service life' means the period between the date an asset is first devoted to public service
7 and the date of its retirement from service. (Emphasis added)
8

9 The USOA requires that depreciation expense be calculated using the "straight line method"
10 over the "service life."

11 Under "Depreciation Accounting", the USOA requires that:

12
13 ...the loss in service value of the property ...be... distributed under the straight-line
14 method during the service life of the property." (Emphasis added, §32.2000(g)(1))
15

16 That service life ends when the investment is "withdrawn from service". (USOA Part
17 32.2000(d))
18

19 The required "straight-line method" means:

20
21 The **straight line** method distributes the cost of property in equal annual amounts, as
22 nearly as is practicable, over its life. This includes the "average service life" and
23 "remaining life" procedures.¹⁴
24

25 Mr. Wu's claim that proper depreciation rates should be calculated over a life that is shorter than
26 the "service life" violates the applicable depreciation standards.
27

28 Q. MR. WU CLAIMS THAT MONITORING THE RETIREMENTS IS NOT A WAY OF
29 MONITORING THE ACTUAL LEVEL OF "MODERNIZATION."¹⁵ IS THAT A VALID
30 ARGUMENT?

1 A. No. Modernization is the replacement of existing equipment with new equipment. Such
2 replacement involves the retirement of existing equipment. Therefore, this is a valid way to
3 monitor modernization. In his Rebuttal, Mr. Wu acknowledges that the Company must invest in
4 new equipment in order to retire the existing equipment.¹⁶

5
6 As previously discussed, the depreciation calculations assume a specific pattern of future
7 retirements. Therefore, Qwest's retirement performance can be compared to what was
8 specifically expected when calculating the depreciation parameters. However, the depreciation
9 calculations do not assume a specific dollar amount of future new investments. Therefore, new
10 investments are not a standard that can be used to determine whether or not Qwest is complying
11 with what was expected when the depreciation parameters were set.

12
13 In addition, it would not be appropriate to require a certain dollar amount of new investment,
14 because that might encourage the Company to "gold plate" new investments

15
16 Q. MR. WU STATES,

17 Let's assume fiber was placed next to a working 100 pair copper cable. As customers are
18 migrated from copper to fiber, there are fewer and fewer working pairs operating over the
19 copper.¹⁷

20
21 IS THIS "DECLINING USAGE" CLAIM TRUE?

22 A. No. The number of metallic pairs working in 1999 was the highest of any year in history. As

¹⁴ Public Utility Depreciation Practices, page 17, Compiled and Edited by Staff Subcommittee on Depreciation of the NARUC Finance and Technology Committee of the National Association of Regulatory Utility Commissioners.

¹⁵ Page 7, Wu Rebuttal.

¹⁶ Page 7, Wu Rebuttal.

¹⁷ Page 10, lines 15-17, Wu Rebuttal.

1 shown on Schedule WDA-27, ARMIS data shows that in 1990, Qwest in Arizona had 1.9 million
2 metallic pairs working. In 1999, it had 2.6 million metallic pairs working in Arizona. Therefore,
3 the basis for Mr. Wu's "declining usage" claim is simply false.¹⁸ In addition, a higher percent of
4 the available metallic cable pairs are in use now, than in 1990. In 1990, 59% of Qwest's copper
5 pairs in Arizona were "working." In 1999, over 67% of Qwest's copper pairs in Arizona were
6 "working", as is shown on Schedule WDA-27.

7

8 Q. DID MR. WU MISSTATE YOUR POSITION?

9 A. Yes. Mr. Wu states,

10 First, Mr. Dunkel recommends that Qwest's retirements of assets be monitored and that
11 Qwest customers be credited if retirements do not equal the depreciation expense Qwest
12 books each year.¹⁹

13

14 This is a misstatement of my testimony. In discovery, Staff asked Mr. Wu to provide a citation
15 to my testimony that supported his characterization of my position. Mr. Wu was unable to do
16 so.²⁰ What I actually proposed was:

17 I propose that each year the actual retirements that USWC makes in Arizona be compared
18 to the expected retirements that were incorporated in the approved depreciation lives."²¹

19

20 In several other instances, Mr. Wu again misconstrues my testimony. For example, he broadly
21 asserts that "ratepayers pay rates for the use of assets that have already placed into service"²²,
22 implying that my testimony is inconsistent with this broad statement. This statement does not

¹⁸ Information from the Depreciation case clearly demonstrates that the majority of the copper cable is used in the "distribution" portion of the network.

¹⁹ Page 6, lines 9-12, Wu Rebuttal.

²⁰ Qwest response to Request WDA 34-005.

²¹ Page 8, lines 20-22, Dunkel Depreciation Direct.

²² Page 6, lines 19-20, Wu Rebuttal.

1 conflict with anything in my testimony. The remaining lives used in my calculations are the
2 remaining lives of the investment that was "already placed in service" by the end of the test year.

3
4 Q. WHAT DO YOU RECOMMEND ON THIS ISSUE?

5 A. In the Depreciation proceeding, the Commissioners were interested in assuring in this case that

6 Qwest would actually make the modernizations that were assumed in the depreciation rates.²³

7 Those depreciation rates were calculated assuming a very high rate of future modernization by

8 Qwest in Arizona. When the rates from this case go into effect, customers will be paying

9 approximately \$10 per line per month for intrastate depreciation expense. Mr. Wu's proposal

10 that Qwest not be accountable to actually make the modernizations that the Commission

11 approved depreciation parameters expected them to make (and which Arizona customers will be

12 paying for in their rates), should be rejected.

13
14 I recommend the Commission adopt the Modernization Accountability Credit presented in my

15 Direct Depreciation testimony. Mr. Wu's claim that retirements are not used in the calculation of

16 depreciation rates is simply false. His claim that the number of pairs in the metallic cables that

17 are actually being used is declining is also false.

18
19 **C. TEST YEAR DEPRECIATION EXPENSE**

20
21 Q. IN YOUR DIRECT TESTIMONY, YOU DEMONSTRATED THAT MR. WU HAD USED

22 THE 1/1/97 RESERVE PERCENT IN CALCULATING WHAT HE PRESENTED AS THE

²³ Tr. 46-47 and 52, April 25, 2000 Open Meeting.

1 CHANGE IN THE TEST YEAR DEPRECIATION EXPENSE. YOU PROPOSED THAT
2 INSTEAD THE TEST YEAR DEPRECIATION EXPENSE SHOULD BE CALCULATED BY
3 APPLYING THE ACC APPROVED PARAMETERS TO THE TEST YEAR 12/31/99 BOOK
4 RESERVE AND INVESTMENT FIGURES. HOW DID MR. WU RESPOND TO THAT
5 ISSUE?

6 A. Mr. Wu provided a new schedule on which he did correct the above-referenced error. Rebuttal
7 Exhibits KDW-1 and Exhibit KDW-2 do show the depreciation rates that Mr. Wu has calculated
8 by applying the ACC approved depreciation parameters to the 12/31/99 "per book" investments
9 and reserves. For the majority of these accounts, the depreciation rates that Mr. Wu has now
10 calculated are identical to the depreciation rates that I had calculated based upon the updated test
11 year. This can be seen by comparing Column L of Schedule WDA-6, page 1 attached to my
12 Direct Depreciation testimony to Column E of Rebuttal Exhibit KDW-1.

13
14 However, his revised schedule contains a new problem. The major difference between Mr. Wu's
15 Rebuttal Exhibits KDW-1 and KDW-2 calculation and my Schedule WDA-6 calculation, is in
16 the treatment of the Analog Switching Equipment account. In his Rebuttal testimony, Mr. Wu's
17 annual depreciation accrual for this Account is \$63 million,²⁴ which is \$45 million more than his
18 original proposal for this Account.

19
20
21
22

²⁴ Rebuttal Exhibit KDW-1, Column E.

1 **D. MR. WU DID NOT USE THE ACC APPROVED DEPRECIATION**
2 **PARAMETERS FOR THE ANALOG SWITCHING OR COMPANY**
3 **COMMUNICATIONS ACCOUNTS**
4

5 Q. WERE THE DEPRECIATION RATE AND EXPENSE THAT MR. WU INCLUDES IN HIS
6 REBUTTAL EXHIBITS KDW-1 AND KDW-2 CALCULATED BASED UPON THE
7 COMMISSION APPROVED PARAMETERS FOR THE ANALOG SWITCHING
8 EQUIPMENT ACCOUNT?

9 A. No. The Commission approved average year of final retirement for this Account is 2000.0, as
10 Mr. Wu was well aware. If you look at Mr. Wu's Direct testimony, Exhibit KDW-1, page 6, you
11 will see that Mr. Wu was aware that the Commission approved average year of final retirement
12 for this Account is 2000.0.

13
14 However, in his new calculation, Mr. Wu did not use 2000.0. Instead, Mr. Wu created his own
15 average year of final retirement of 2000.5, and that is what he used in his rebuttal calculations for
16 the Analog Switching Equipment account.

17
18 Attached as Schedule WDA-28 is a copy of the Qwest provided workpaper which supports Mr.
19 Wu's Rebuttal Exhibits KDW-1 and KDW-2 for Analog Switching Equipment.²⁵ As can be seen
20 near the top of page 4 of this Schedule, Mr. Wu used an average year of final retirement (AYFR)
21 of 2000.5.²⁶ That is not the Commission approved AYFR.

22

²⁵ The attached Schedule shows the workpapers for the Analog Switching Equipment account. The response also contained workpapers for other accounts, as well.

²⁶ I added the box around that figure for emphasis.

1 Q. WHAT IS OCCURRING IN THE ANALOG SWITCHING ACCOUNT THAT IS DIFFERENT
2 FROM ANY OTHER ACCOUNT?

3 A. This account is a dying account. By the time this case goes to the Commission, there will be no
4 investments in this account. The last switch in this Account is scheduled to retire in October,
5 2000, only one month from now.²⁷

6
7 In addition, the Company's retirement schedule is now different than had been filed in the
8 Depreciation case. Among other factors, this different retirement schedule will result in some of
9 the investments in this Account not being fully depreciated by the time the last investments in the
10 Account are retired. According to the Company's new schedule, the last investment in this
11 Account will retire in October, 2000.²⁸ The retirement schedule that was utilized in the
12 Depreciation proceeding, did not project that the last investment in this Account would retire
13 until the year 2004.²⁹ Since the last retirement in this Account has been moved forward by four
14 years, there is now less remaining life over which to depreciate the investment, which will result
15 in a deficiency occurring. The question is how to treat that deficiency.

16
17 Q. WHAT DOES MR. WU'S PROPOSAL FOR THE ANALOG SWITCHING ACCOUNT
18 EFFECTIVELY DO?

19 A. The undepreciated intrastate investment in this Account at the end of 1999 was \$63,170,000.
20 This is calculated as follows:

21

²⁷ Qwest response to Request WDA 34-018.

²⁸ Qwest response to Request WDA 34-018.

²⁹ Page 9, Qwest's 1997 State Depreciation Rate Study-Arizona, Analog Switching Equipment Account 2211, Docket No. T-01051B-97-0689.

1	12/31/99 investment	\$110,824(000) (Rebuttal Exhibit KDW-1, Column A)
2	12/31/99 reserve ³⁰	- 47,654(000)
3	Undepreciated investment	\$ 63,170(000)
4		

5 As can be seen from Rebuttal Exhibit KDW-1, \$63,170(000) is the depreciation accrual for this
6 Account that Mr. Wu proposes to be recovered in one year. Mr. Wu has adjusted the AYFR
7 figure so as to effectively propose recovering the full undepreciated amounts that remain in this
8 Account as of 12/31/99 over only a one year period. Of course, the one year period for which
9 Mr. Wu proposes to make this huge recovery is the one year that the Company would use to
10 calculate the "typical" depreciation expense to be incorporated in the customers' rates. Those
11 customers' rates will be in effect for many years into the future, and it would be unfair to build in
12 this sort of huge expense when it is not at all representative of normal expense levels.

13

14 Q. WHAT TREATMENT DO YOU RECOMMEND FOR THIS DEFICIENCY?

15 A. The proper treatment for this undepreciated amount is to amortize it over a reasonable period. I
16 recommend that the deficiency which exists in this Account be amortized at the rate of \$1.5
17 million per month, which is \$18 million per year. Qwest would continue to book that
18 amortization until the full amount of the deficiency had been recovered. The exact period over
19 which that amortization would be booked would depend upon what specific deficiency was left
20 after the last switch is retired, but that amortization period would be approximately three years.³¹
21 Amortization over a reasonable period is appropriate. This deficiency was not created in one
22 year, and should not be recovered in one year.

³⁰ \$110,824,000 x 43% = \$47,654,000. 43% is from Rebuttal Exhibit KDW-2.

³¹ The undepreciated intrastate amount at the end of 12/31/93 was \$63,170,000. If this was the deficiency that existed at the time the last switch was retired, then the amortization I propose would recover that deficiency in three and one-half years. However, there are depreciation accruals occurring in the year 2000. That will reduce the

1
2 To arbitrarily assign all of the recovery of that deficiency to just a one year period is
3 inappropriate, and over-burdens the claimed expense during that one year period. These are not
4 costs that were all actually incurred in that one year period. Therefore, those costs should be
5 amortized over a several year period. Arbitrarily assigning all of these costs to just that one year
6 period overstates the actual cost of service during that period.³²
7

8 Amortizing an unusual reserve amount over several years is a well recognized and accepted
9 procedure. For example, in ACC Docket No. U-1345-86-062/85-367 (Decision No. 55931), the
10 Commission amortized certain excess deferred income tax reserve over a five year period.
11

12 Q. CAN YOU DEMONSTRATE THE ABSURDITY OF SETTING CUSTOMER RATES BASED
13 ON \$63 MILLION RECOVERY OF THE ANALOG SWITCHING DEFICIENCY IN ONE
14 YEAR?

15 A. Yes. It is reasonable to expect the customers' rates set in this case will be in effect for several
16 years.³³ Under Mr. Wu's Rebuttal proposal, the customers' rates would be set to include \$62.3
17 million in annual depreciation expense for the Analog Switching Equipment. However, that is
18 not a true one year expense, nor is it typical. The intrastate depreciation rates that Qwest actually
19 booked for this Account in 1999 was less than \$10 million. The intrastate depreciation accruals

deficiency below the \$63,170,000 level. Therefore, the amortization would actually apply for less than three and one-half years.

³² Prior to filing my Direct testimony, I looked at what had been occurring in this Account, and had determined that the \$17,953,000 annual depreciation expense that Mr. Wu had included in his original testimony for this Account was a reasonable figure that reflected a reasonable annual recovery of the investment in this Account, and adopted it, as shown on Schedule WDA-6, page 1. My original conclusion is valid.

³³ Even if an alternative regulatory structure is established, those structures normally use the "going in" rates as the starting point. Those going in rates may be adjusted up or down based upon productivity and inflation factors, but

1 for this Account that Qwest will actually book in the year 2000 will be less than \$10 million.³⁴
2 The depreciation expense for this Account that Qwest will book in future years after 2000, will
3 be zero if Mr. Wu's proposal is adopted. (After the year 2000, there will be no investment in this
4 account to which a depreciation rate would apply.) Amortizing this amount at \$18 million per
5 year over a several year period is a more reasonable treatment, and recognizes that this expense
6 was actually incurred over a several year period, and therefore should be amortized over a
7 several year period.

8
9 Q. IN ADDITION TO DISCUSSING THE ANALOG SWITCHING ACCOUNT, MR. WU
10 DISAGREES WITH HOW YOU "ROUNDED" CERTAIN NUMBERS, AND HOW YOU
11 "COMPOSITED" CERTAIN ACCOUNTS.³⁵ ARE ANY OF THESE ISSUES SIGNIFICANT?

12 A. No. "Rounding" the way Mr. Wu proposes actually slightly increases the depreciation accruals
13 over my figure. Adopting Mr. Wu's position on these "rounding" and "composited" issues
14 increases the intrastate annual accrual by approximately \$100,000. On Schedule WDA-29, I
15 have adopted Mr. Wu's proposed "rounding" and "composited" methods, so these are no longer
16 issues.

17
18 Q. IS MR. WU'S TREATMENT OF COMPANY COMMUNICATIONS EQUIPMENT
19 CONSISTENT WITH THE ACC ORDER?

the going in rate continues to influence the actual rates for many years in the future.

³⁴ Qwest is currently booking a 16.2% depreciation rate for this Account, which produces an annual depreciation rate of less than \$10 million. When applied to the investment at the start of the year (Rebuttal Exhibit KDW-1). This produces less than \$10 million of depreciation accrual, and the expense will actually be much less than that because the investment will decline over the year.

³⁵ Page 11, line 20 through page 12, line 4, Wu Rebuttal. Qwest response to Request WDA 34-009.

1 A. No. For this account, the depreciation rates that Mr. Wu proposes in his Direct and Rebuttal
2 testimonies, were not calculated using the Commission approved "projection life" parameters.
3 The depreciation rate that Qwest is currently booking also does not apply the Commission-
4 approved "projection life" parameter to this Account. In its Decision No. 61645, Finding of Fact
5 21 states:

6 Staff's inputs concerning projection life, survivor curves and salvage parameters are
7 appropriate and should be utilized with the ELG approach.
8

9 The Commission adopted the parameters that had been proposed by Staff.³⁶ Therefore, the
10 Commission adopted the projection life and other parameters for this Account that had been
11 presented by Staff witness Dr. Le. In his July, 1998 Direct testimony, Appendix A, and his
12 April, 1999 Supplemental Schedule 12, Dr. Le had recommended an average projection life of
13 8.5 years for Account 2123.2. However, when Qwest filed the depreciation rates it was currently
14 booking, Qwest used a projection life of 8.3 years for this Account. Soon after the Company
15 started booking these new depreciation rates, Staff informed Qwest that the projection life Qwest
16 was using for this Account was inconsistent with the ACC Order. However, Qwest did not
17 correct those rates. The depreciation rates that Mr. Wu advocates in his Direct testimony are also
18 calculated utilizing the 8.3 year projection life which is inconsistent with the Commission
19 Order.³⁷ The revised depreciation rates that Mr. Wu presented in his Rebuttal testimony also
20 improperly utilize the 8.3 year projection life.
21

³⁶ The Order identified seven accounts for additional analysis. Company Communications Equipment Account was not one of those seven accounts.

³⁷ Exhibit KDW-1, page 6, Wu Direct.

1 In addition, Mr. Wu indicated that one of the errors he alleges exists in my depreciation rates is
2 that I calculated the remaining life for this Account using the Commission approved parameter of
3 8.5 years instead of using the 8.3 year projection life that Qwest is improperly utilizing.³⁸

4
5 When I first noticed this problem many months ago, I first assumed the Company simply had a
6 typographical error. However, Mr. Wu has now repeatedly utilized this incorrect projection life.
7 Mr. Wu's allegation, in his Rebuttal testimony and the supporting discovery responses, that my
8 remaining life calculation is in error because I used the Commission approved 8.5 year
9 projection life, is invalid.

10
11 Q. IS THERE ANY ADDITIONAL ERROR IN MR. WU'S REVISED DEPRECIATION RATE
12 CHANGE IMPACT ON REBUTTAL EXHIBIT KDW-1?

13 A. Yes. Mr. Wu shows an increase of \$575,000 for Public Telephone Terminal Equipment,
14 Account 2351. However, as Mr. Wu acknowledged in discovery, the investment in this account
15 is deregulated, and:

16 Public Telephone Terminal Equipment should not have a depreciation accrual change
17 shown in the last column of Rebuttal Exhibit KDW-1. This reduces the total by \$575K.³⁹
18

19 **E. RECOMMENDED DEPRECIATION AND AMORTIZATION**

20
21 Q. WHEN THE DEPRECIATION AND AMORTIZATION IS PROPERLY CALCULATED,
22 WHAT IS THE CHANGE IN ANNUAL EXPENSE THAT RESULTS FROM THE CHANGE
23 IN RATES?

³⁸ Qwest response to Request WDA 34-009.

1 A. As shown on Schedule WDA-29, the change in depreciation accruals which results from the
2 change in depreciation rates is \$68,409,000. This compares to **\$ ** that was
3 originally contained on Schedule WDA-6, page 1 of my Direct. This is a change of
4 approximately **\$.**⁴⁰

5
6 Q. WHAT DO YOU RECOMMEND?

7 A. I recommend that the depreciation rates and amortization shown on Schedule WDA-29 be
8 adopted. These rates are proper. They are calculated by applying the Commission-approved
9 depreciation parameters to the test year (12/31/99) reserve and investment levels. For the
10 Account that will soon be dead, Analog Switching Equipment, this proposal includes a
11 reasonable amortization of the deficiency of \$18 million per year, which will amortize the
12 deficiency over approximately a three year period.

13
14 **III. RESPONSE TO MR. LEE'S TESTIMONY ON BEHALF OF**
15 **THE DEPARTMENT OF DEFENSE**

16
17 Q. IN HIS REBUTTAL, MR. WU GROUPS YOUR PROPOSAL PERTAINING TO
18 DEPRECIATION WITH MR. LEE'S.⁴¹ IS YOUR PROPOSAL PERTAINING TO THE
19 DEPRECIATION EXPENSE CALCULATION SIMILAR TO MR. LEE'S?

³⁹ Qwest response to Request WDA 34-013C.

⁴⁰ In addition, as discussed in my Direct testimony, there is also an adjustment that moves the depreciation expense from the mid-year to the end-of-year investment that adds approximately another \$10 million to the intrastate depreciation expense adjustment. (Schedule WDA-9) This is not changed by any of the above.

⁴¹ Page i, Wu Rebuttal.

1 A. No. My proposal is very different from Mr. Lee's proposal. Mr. Lee's proposal includes
2 adjusting the 12/31/99 book depreciation reserve to what the reserve would have been had the
3 revised depreciation rates gone into effect 1/1/97.⁴²

4
5 The depreciation rates Staff has proposed are calculated by applying the Commission approved
6 depreciation parameters to the 12/31/99 "per book" investments and depreciation reserves, as
7 those reserves appear on the books of Qwest. Staff did not adjust the "per book" reserve levels
8 to what that number would have been had Qwest been booking intrastate depreciation rates
9 different from those it was actually booking. The depreciation reserve levels used in Staff's
10 calculation are the actual 12/31/99 intrastate depreciation reserve levels of Qwest, as those
11 figures actually appear on their books. Staff does not propose assuming the depreciation rates
12 commence accruing anytime prior to the time they actually commenced accruing. Therefore,
13 Mr. Wu's response to Mr. Lee's testimony does not respond to Staff's proposal.

14 15 IV. RATE DESIGN

16
17 Q. WHAT WAS QWEST'S RESPONSE TO THE STAFF'S CONTRIBUTION ANALYSIS?

18 A. Qwest's entire rebuttal to the Staff's contribution analysis is found on page 19 of Mr. Teitzel's
19 Rebuttal testimony. Mr. Teitzel only argues that since Staff's contribution analysis treats the
20 loop as a shared facility, the Staff's contribution analysis is invalid. The corollary to this
21 argument is if the loop facility is a shared facility, Staff's contribution analysis is valid. As
22 discussed in my Rate Design Direct, that analysis showed that the revenues for 1FR service were

⁴² Page 13, lines 7-9, Lee Direct, July 25, 2000. Also see Column E, Attachment 1, page 1.

1 greatly exceeding its properly calculated TSLRIC. That analysis also showed that residential
2 basic exchange service currently contributed more towards the recovery of joint, shared, and
3 common costs of providing telecommunications services in Arizona than does toll, switched
4 access, or even vertical service.

5
6 **A. THE LOOP IS A SHARED FACILITY**
7

8 Q. ON PAGE 16 OF HIS REBUTTAL, DR. TAYLOR REFERS TO YOUR DETERMINATION
9 THAT THE LOOP IS A SHARED FACILITY WHEN HE STATES "MR. DUNKEL'S
10 CONCLUSION IS CONTRARY TO SOUND ECONOMIC PRINCIPLES AND BASED ON A
11 MISUNDERSTANDING OF ECONOMIC COSTS AND THE COST RECOVERY
12 PROCESS." IS THERE ANYTHING IRONIC ABOUT DR. TAYLOR'S STATEMENT?

13 A. Yes. The irony lies in the fact that Dr. Taylor's conclusion that the loop facility is not a shared
14 facility is based upon Dr. Taylor's misunderstanding of the way the telecommunications network
15 is engineered. The fact of the matter is that the telecommunications network is engineered such
16 that a number of different services share and depend upon the loop facilities. Even if any one of
17 the services that depends upon the loop facilities is discontinued or eliminated from the network,
18 while Qwest continues to provide all other services that depend upon the loop facilities, the loop
19 facilities would still be required.

20
21 For example, if Qwest were to discontinue or eliminate basic exchange service, while it
22 continued to provide toll, switched access and vertical services, the loop facilities would still be
23 required because a loop facility is necessary to provide toll, switched access and vertical

1 services. In my Direct Testimony Exhibit WDA-17, I graphically depicted the network facilities
2 that are required to provide Toll, Vertical Services, Switched Access, Basic Local Service and
3 ADSL high-speed internet services. As this Schedule demonstrates, all of these services require
4 the loop facilities. If any one of these services are eliminated, while the rest of the services
5 continue to be provided, the loop facilities would continue to be required. This is an engineering
6 fact. The telecommunications network is engineered such that none of these services can be
7 provided without a loop facility. There are no economic principles or theories that can explain
8 away the fact that some loop facility is required to provide all of these services.

9
10 Q. ON PAGE 16 OF HIS REBUTTAL, DR. TAYLOR CLAIMS THAT YOUR POSITION THAT
11 THE LOOP IS A SHARED FACILITY THAT SHOULD NOT BE INCLUDED IN THE
12 TSLRIC OF BASIC EXCHANGE SERVICE, OR ANY OTHER SERVICE THAT SHARES
13 THE LOOP FACILITY, "HAS BEEN THOROUGHLY DISCREDITED IN THE
14 ECONOMICS LITERATURE." WHAT "ECONOMICS LITERATURE" DOES DR. TAYLOR
15 REFER TO?

16 A. The "economics literature" that Dr. Taylor refers to were two articles that were authored by Dr.
17 Taylor or other individuals who are well known for their work as witnesses who testify of behalf
18 of telephone companies. All authors of the two articles he referenced are also currently, or have
19 been, associated with Dr. Taylor's firm.⁴³

20

⁴³In Footnote 15 on page 16 of his Rebuttal, Dr. Taylor refers to two articles. One article was co-authored by A.E. Kahn, who is well known for testifying on behalf of LECs and was a special consultant to the firm that Dr. Taylor works for National Economic Research Associates, Inc. (NERA) at the time the article was published, and William Shew, who was the Vice-President of NERA at the time the referenced article was published. The other article was authored by Dr. Taylor himself.

1 In contrast, I have supported my view of the loop facilities as shared facilities, by citing
2 numerous regulatory authorities. On pages 49-55 of my Direct Testimony in this proceeding, I
3 provided citations to the Supreme Court, the FCC, the Joint Board, the orders of the commissions
4 in a number of other states and NARUC, which all support my view that the loop is indeed a
5 shared facility.

6
7 Q. DID YOU RELY UPON "SOUND ECONOMIC PRINCIPLES" WHEN YOU MADE YOUR
8 DETERMINATION THAT THE LOOP FACILITY SHOULD NOT BE INCLUDED IN THE
9 TSLRIC OF BASIC EXCHANGE SERVICE?

10 A. Yes, as was discussed in the Direct testimony filed by Thomas Regan. In fact, I relied upon the
11 exact same economic principles that Qwest claims to rely upon (but misapplies) when
12 calculating the TSLRIC of basic exchange service. The Qwest cost studies state the following:

13 **Total Direct Costs** - Total Direct cost is the total forward-looking direct cost of
14 providing a product or service to the total universe of U S WEST customers. It most
15 closely reflects the cost of replacing all the facilities directly required to provide that
16 product or service. It does not include costs that are required but which also benefit the
17 provision of other products and services. It reflects the forward-looking cost of the entire
18 service provided in the most efficient manner, holding constant the production of all other
19 services produced by the firm. This cost has frequently been referred to as TSLRIC.⁴⁴
20 (Emphasis added)
21

22 As I pointed out on page 38 of my Rate Design Direct Testimony, Qwest defines TSLRIC as the
23 following:

24 The TSLRIC studies identify the total cost of offering the service - defined as the total
25 costs incurred by U S WEST while offering the service, less the total costs that would be
26 incurred by U S WEST if the service were not offered.⁴⁵ (Emphasis added)
27

⁴⁴ Thompson Direct, Exhibit JLT-1, page 7.

⁴⁵ Thompson Direct Testimony, page 4, line 23.

1 Using Qwest's claimed definition of TSLRIC above, the TSLRIC is found by identifying the
2 difference between "the total costs incurred by U S WEST while offering the service" and "the
3 total costs that would be incurred by U S WEST if the service were not offered."
4

5 The "total costs incurred by U S WEST" while offering basic exchange service, toll, switched
6 access, vertical services, etc., would include the loop facility costs. Likewise, the "total costs
7 that would be incurred by U S WEST" if basic exchange service were not offered (while
8 continuing to provide toll, switched access, vertical services, etc.) would also include the loop
9 facility costs. Eliminating basic exchange service while continuing to provide toll, switched
10 access, and vertical services, would not eliminate the cost of the loop. A facility of some type to
11 deliver traffic to and from the premise (the loop) would be required even if basic exchange
12 service was not provided, while the other services were provided. Therefore, even relying upon
13 Qwest's own definition of TSLRIC, the loop facility costs are not properly included in the
14 TSLRIC of basic exchange service.
15

16 In order to determine what costs would be incurred under these two scenarios, you must properly
17 recognize how the telecommunications network is engineered, and what facilities would continue
18 to be required if a particular service is no longer offered, while continuing to provide all other
19 services. This is where Dr. Taylor makes his critical error. Dr. Taylor fails to properly
20 recognize that loop facilities would be required to provide toll, switched access, vertical services
21 and the other services that share the loop facilities, even if basic exchange service were to be
22 discontinued or eliminated. It is an undeniable physical fact that a loop facility would be

1 required to provide toll, switched access, vertical services and other services, even if basic
2 exchange service were not provided.

3
4 Q. ON PAGE 17 OF HIS REBUTTAL, DR. TAYLOR ARGUES THAT THE FUNDAMENTAL
5 PRINCIPLE HE RELIES UPON TO FORM HIS CONCLUSION ABOUT HOW THE COST
6 OF THE LOOP SHOULD BE ASSIGNED IS "COST CAUSATION." CAN YOU PROVE
7 THAT THE LOOP FACILITY COSTS ARE NOT SOLELY "CAUSED BY" BASIC
8 EXCHANGE SERVICE?

9 A. Yes. In discovery, Qwest admitted that if a certain cost is not avoided when a service is
10 eliminated or discontinued, while continuing to provide all other services, that cost is not
11 considered to be "caused" by the provision of the service in question. The relevant data request
12 and Qwest's response are as follows:

13 Data Request WDA 2-7 (b):
14

15 Request: Is it a correct statement that if a company does not avoid certain costs in the long
16 run when a service in question is eliminated (or not offered), while holding
17 constant the production of all other services produced by the Company, those
18 costs which are not eliminated if the service in question is eliminated are not
19 properly considered to be "caused" by the provision of the service in question?
20

21 Response: Generally, yes.
22
23

24 As discussed above, the loop facilities would continue to be required to provide toll, switched
25 access, vertical services and other services, even if basic exchange service were not provided.
26 Therefore, since the loop cost would not be eliminated if basic exchange service were eliminated,
27 while holding constant the production of all other services produced by Qwest, the loop facility
28 costs cannot possible be considered to be "caused" by the provision of basic exchange service.

1 This determination is based upon the principle that Qwest admitted it agrees with, as
2 demonstrated above.

3
4 Q. ON PAGE 22 OF HIS REBUTTAL, DR TAYLOR STATES:

5 If Qwest were to decide to cease the supply of all services except for basic exchange
6 service, it would not avoid the cost of the loop. But, if it decided to withdraw only its
7 basic exchange service - specifically, the network access part - and kept all the other
8 services, then it would definitely avoid the cost of the loop, just as long distance carriers,
9 alarm companies, and other enhanced service providers do.

10
11 WHAT IS WRONG WITH DR. TAYLOR'S ASSESSMENT OF THE LOOP COSTS IN THE
12 ABOVE REFERENCED STATEMENT?

13 A. Long distance carriers, alarm companies, and enhanced service providers do utilize the loop.

14 They do need a loop in order to provide their services. If an alarm company does not build its
15 own loop, it "rents" a loop from the LEC. In order to provide its alarm services, the alarm
16 company does incur the cost of the loop.⁴⁶ The cost of the loop exists whether they are the cost
17 of "ownership" or the cost of "rental." Likewise, if toll carriers do not build their own loops,
18 then they rent the loop facilities from an LEC or CLEC. Again, to provide toll service, loop
19 facilities are required. If an LEC or alarm company rents a loop to provide long distance or
20 alarm services, that loop "rental" is part of the cost of providing those services. Quite simply, if
21 a company attempted to provide toll service without any facility that would connect traffic to and
22 from the customer premises, that toll service would not work.⁴⁷ The IXCs do not get to use

⁴⁶ "Private line" alarm services are different than toll, basic exchange, and vertical services, since "private line" alarm services generally do not share the "switched" loop, but instead may utilize a dedicated private line. However, some alarm services (such as those that use a "dialer" to call in the event of an emergency), may use the "switched" loop. The shared loops discussed in my testimony are the "switched" loops, not the dedicated "private line" loops. The "switched" loops are sometimes referred to as "common lines."

⁴⁷ Even if radio facilities were used, transmission towers, a radio receiver and transmitter at the customer premises would be required. (i.e. wireless loop) There is no "free" technology that allows connection of telecommunications traffic to and from customer premises.

1 Qwest's loops for intrastate services free in Arizona, nor should they. As discussed above, the
2 telecommunications network is engineered such that a loop facility is required to provide toll,
3 switched access, vertical services and other services. Therefore, Dr. Taylor does not explain how
4 Qwest will be able to provide these other services (that depend upon the loop facilities) without
5 the loop facilities. It is a simple physical fact that if a toll call is going to get to a customer
6 premises, there must be some facility to get the toll call there.

7
8 Q. IN ANOTHER STATE, DID DR. TAYLOR ADMIT THAT THE LOOP WOULD STILL BE
9 REQUIRED TO PROVIDE TOLL SERVICE, EVEN IF QWEST CEASED TO PROVIDE
10 BASIC EXCHANGE SERVICE?

11 A. Yes. In New Mexico Utility Case No. 3008, which is a general rate case of Qwest, Dr. Taylor
12 specifically admitted that the loop facilities would continue to be required to provide toll, even if
13 Qwest ceased to provide basic exchange service. Dr. Taylor stated as follows:

14 If U S WEST ceased the supply of all services - including the network access (or loop)
15 portion of basic exchange service - but continued to provide toll service, then a
16 replacement loop facility would be needed to transmit toll messages to and from the end-
17 user. Whether it is used to carry basic exchange usage services or toll service, or both,
18 the loop would still be needed to provide connectivity to the relevant network.⁴⁸
19
20

21 As it is clear from his response referenced above, Dr. Taylor has recognized the fact that the loop
22 would be needed to provide toll services, even if Qwest ceased to provide basic exchange
23 service. The same principle applies to Qwest's toll services in Arizona.

24

⁴⁸New Mexico Utility Case No. 3008, Qwest's response to Data Request PRC 32-145 (Respondent: Dr. Taylor).

1 Q. DESPITE THE FACT THAT HE RECOGNIZES THE FACT THAT THE LOOP FACILITY
2 WOULD STILL BE REQUIRED TO PROVIDE OTHER SERVICES, EVEN IF BASIC
3 EXCHANGE SERVICE WERE NOT OFFERED, WHAT IS ONE WAY DR. TAYLOR
4 ATTEMPTS TO JUSTIFY ATTRIBUTING ALL OF THE LOOP COSTS TO BASIC
5 EXCHANGE SERVICE?

6 A. Dr. Taylor attempts to justify attributing all of the costs of the loop facility to basic exchange
7 service by suggesting that basic exchange service is the only service that requires "network
8 access." Dr. Taylor states:

9 First, because residential basic exchange service is really an integrated offering of two
10 distinct and separable services - non-usage-sensitive network access and local usage - any
11 withdrawal of that integrated service will mean that Qwest will avoid not just the cost of
12 local usage service but also the network access service (the loop).⁴⁹
13
14

15 Q. IS DR. TAYLOR'S CLAIM THAT BASIC EXCHANGE SERVICE INCLUDES "NETWORK
16 ACCESS" SUFFICIENT TO JUSTIFY ATTRIBUTING THE LOOP COSTS SOLELY TO
17 BASIC EXCHANGE SERVICE?

18 A. No. As discussed above, many services require access to the network in order to be provided.
19 Toll, switched access, vertical services and ADSL high-speed internet access services all require
20 "network access." Without access to the loop facilities, the provision of these services would not
21 be possible. Therefore, Dr. Taylor's assumption that basic exchange service is the only service
22 requiring or providing "network access" is simply wrong. For example, in order to deliver a toll
23 call, the toll carrier must gain "network access" to the loop facilities that are required to deliver
24 the toll call. Even if there were no basic exchange service offered, a loop would be needed for
25 other services, including toll, vertical services, ADSL high-speed Internet access service and

⁴⁹Taylor Rebuttal, page 20, lines 17-21.

1 other services. Therefore, pointing out that basic exchange service requires access to the loop
2 facilities does nothing to advance the flawed argument that the loop facilities costs should be
3 considered solely a cost of basic exchange service. The simple fact is that many services in
4 addition to basic exchange service require access to the shared loop facilities.

5
6 Q. IS THERE ANOTHER WAY THAT DR. TAYLOR ATTEMPTS TO JUSTIFY
7 ATTRIBUTING ALL OF THE LOOP COSTS TO BASIC EXCHANGE SERVICE?

8 A. Yes. Dr. Taylor offers another flawed attempt to justify his position. On page 21 of his
9 Rebuttal, Dr. Taylor alleges that long distance carriers (IXCs) get to use the loop facilities owned
10 by the LECs for free, therefore the IXCs are able to provide toll service and avoid the cost of the
11 loops. However, Dr. Taylor's claim is not true. As discussed in my Direct testimony, the IXCs
12 must pay Qwest for sharing the common lines (loops) that Qwest owns, and the IXCs need to use
13 to provide toll services to their end-users. Specifically, the IXCs pay Qwest an intrastate Carrier
14 Common Line Charge (CCLC) to share the loop facilities owned by Qwest. The CCLC is the
15 switched access charge by which Qwest recovers a portion of the loop facilities costs from the
16 IXCs. The specific name for the service from Qwest's tariff that the IXCs obtain in exchange
17 for paying the CCLC is called "Carrier Common Line Access Service." This service is described
18 in Qwest's tariff as follows:

19
20 3. CARRIER COMMON LINE ACCESS SERVICE

21 3.1 GENERAL DESCRIPTION

22 Carrier Common Line Access Service provides for the use of Company common lines by
23 customers for access to end users to furnish intrastate telecommunications service. The
24 Company will provide Carrier Common Line Access Service (Carrier Common Line

1 Access) to customers in conjunction with Switched Access Service provided in Section 6
2 of this Tariff.
3

4 In Arizona, the IXC's pay an average of **\$ ** per-line per month for the CCLC to use
5 Qwest's loop facilities to provide intrastate toll services.⁵⁰ The calculation of this figure is shown
6 on Schedule WDA-30. Therefore, Dr. Taylor's assumption that the IXC's get to use Qwest's loop
7 facilities for free is false. The IXC's quite properly incur a cost to share the loop facilities owned
8 by Qwest.
9

10 Q. WOULD IT BE PROPER TO ALLOW THE IXCS TO SHARE THE LOOP FACILITIES FOR
11 FREE?

12 A. No. The result of such a decision would be to provide the toll carriers with a free ride on the
13 loop facilities. Under such an arrangement, the other LEC's services would be forced to carry the
14 burden of recovering all of the loop facilities costs. This would place a disproportionate share of
15 the cost of the shared loop facility on the other services, including basic exchange services.
16

17 A much more rational and reasonable arrangement would be to require the IXC's to contribute
18 toward the recovery of the loop facilities that they share and depend upon. This is exactly the
19 situation that currently exists in Arizona. The IXC's contribute ** ** per line, per-month
20 toward the shared loop facilities costs. Sharing facilities is also a more efficient way than
21 building separate facilities for each service. However, this efficiency can be created only if the
22 services that share the facility also share the cost of the shared facility. All services share a
23 portion of the benefit that comes from sharing the facilities. Having more than one service share

1 a facility, and therefore appropriately share both the benefits and the costs of that shared facility,
2 is promoting efficiency.

3
4 Q. UNDER WHAT CIRCUMSTANCES MIGHT AN LEC BE WILLING TO GO ALONG WITH
5 ALLOWING AN IXC TO SHARE THE LOOP FACILITIES FOR FREE?

6 A. If the LEC had the benefit of a monopoly or near-monopoly service, the LEC could simply
7 recover all of the costs of the shared loop facilities from its own end-users of those monopoly
8 services, and be relatively neutral on the issue. In fact, in his Rebuttal in this proceeding, Mr.
9 McIntyre responded to the concept of shifting revenue requirement from switched access rates,
10 paid by carriers, to the end-users as part of their basic rates. Mr. McIntyre stated:

11 Qwest would receive the revenue from a different source and therefore remain relatively
12 neutral.⁵¹
13
14

15 In addition, switched access service is one of the services that Qwest believes is a potentially
16 competitive service. As discussed on page 3 of his Rebuttal, Mr. McIntyre points out that one of
17 the reasons it wants to reduce switched access rates is to prevent "competitive bypass."
18 Therefore, by supporting reduced switched access rates with monopoly service (i.e. basic
19 exchange service) rate increases, Qwest can discourage competition for the access service (by
20 making the service less profitable), and still "remain relatively neutral" with respect to the total
21 revenues it receives.
22

⁵⁰CCLC Revenues obtained from Qwest's Priceout, Section A3.8R divided by total lines in service, provided by Qwest in response to Data Request WDA 21-13, Attachment A.

⁵¹McIntyre rebuttal, page 3, lines 15-16.

1 However, if the LEC did not have a monopoly service (i.e. the market were competitive for all
2 services, including basic exchange service), the LEC would not have the ability to recover all of
3 the loop facility costs from its end-users. In a truly competitive market where all services are
4 competitive, competition would prevent the LECs from over-burdening one class of customers.
5 If one company attempted to over-recover shared costs from one service, customers of that
6 service would go elsewhere. In competitive markets, there are no "free rides". The "free ride"
7 that some parties are proposing for the IXC's on the loop facilities could be supported only by
8 extracting a disproportionate recovery of the cost of the shared facilities from the other services,
9 primarily basic exchange services.

10
11 Q. BEGINNING ON PAGE 26, LINE 28 OF HIS REBUTTAL, DR. TAYLOR ARGUES THAT
12 SINCE THE LOOP FACILITIES COSTS ARE NON-TRAFFIC SENSITIVE, THE LOOP
13 COSTS MUST BE RECOVERED FROM BASIC EXCHANGE SERVICE RATES. DOES
14 THE FACT THAT THE LOOP COSTS ARE NON-TRAFFIC SENSITIVE MEAN THAT
15 BASIC EXCHANGE RATES MUST RECOVER ALL OF THE LOOP COSTS?

16 A. No. Even if the loop facilities costs are non-traffic sensitive, this does not in any way implicate
17 basic exchange service as the sole cause of the loop facility costs. A bill to recover a portion of
18 the "fixed" costs could be sent to the IXC's just as easily as being sent to the end users. The
19 "fixed" costs are a part of almost any business. For example, in a fast food restaurant, the "rent"
20 may be a "fixed" cost that does not vary based upon the number of hamburgers and hot dogs
21 sold. However, although the rent is a fixed cost, it is a cost that must be recovered. Therefore,
22 the pricing of the hamburgers, hot dogs, and other products sold must be set so as to not only
23 cover the incremental cost of those products, but also cover the "fixed rent" costs as well.

1

2 Q. HAS THE FCC SPECIFICALLY INDICATED THAT THE LOOP FACILITY COSTS
3 CANNOT BE ALLOCATED ON THE BASIS OF COST CAUSATION?

4 A. Yes. The FCC has specifically stated the following:

5 By contrast, the costs of other facilities used for both interstate and intrastate traffic do
6 not vary with the amount of traffic carried over the facilities, i.e., the costs are non-traffic
7 sensitive. These costs pose particularly difficult problems for the separations process: the
8 costs of such facilities cannot be allocated on the basis of cost-causation principles
9 because all of the facilities would be required even if they were used only to provide local
10 service or only to provide interstate access. A significant illustration of this problem is
11 allocating the cost of the local loop, which is needed both to provide local telephone
12 service as well as to originate and terminate long distance calls.
13
14

15 Q. WOULD IT BE POSSIBLE TO IMPLEMENT A PRICING POLICY WHERE THE LOOP
16 FACILITY COSTS ARE RECOVERED THROUGH FLAT-RATED CHARGES FROM EACH
17 OF THE SERVICES THAT SHARE THE LOOP FACILITY?

18 A. Yes. If Qwest's true concern was that the loop facility costs be recovered through flat-rated
19 charges for the recovery of the loop facilities, rather than per-minute charges, Qwest could
20 propose a flat-rated monthly charge for each of the services that share the loop. Including the
21 services to the IXC's, Staff is not proposing any such charge in this proceeding. However, if the
22 concern truly was the "form" of the current billing to the IXC's, then it would be more reasonable
23 to change the "form" of the billing to the IXC's, than it would be to give the IXC's a free ride on
24 the loop facilities.
25

26 Q. IN HIS REBUTTAL, MR. THOMPSON RAISES A NUMBER OF THE SAME ARGUMENTS
27 THAT DR. TAYLOR RAISED IN HIS REBUTTAL REGARDING THE TREATMENT OF
28 THE LOOP FACILITY COSTS. DOES YOUR SURREBUTTAL RESPONSE TO DR.

1 TAYLOR'S REBUTTAL SERVE AS APPROPRIATE REBUTTAL TO MR. THOMPSON'S
2 REBUTTAL AS WELL?

3 A. Yes. Instead of repeating the same arguments in response to Mr. Thompson's Rebuttal, my
4 Surrebuttal to the issues raised by Dr. Taylor serves as the appropriate response to a number of
5 the same or similar arguments contained in Mr. Thompson's Rebuttal as well.
6

7 Q. ON PAGE 14 OF HIS REBUTTAL, MR. THOMPSON ADMITS THAT PURSUANT TO THE
8 SUPREME COURT'S DECISION AND THE FCC'S RULES, 25% OF THE LOOP
9 FACILITIES COSTS ARE ALLOCATED TO THE INTERSTATE JURISDICTION.
10 HOWEVER, MR. THOMPSON CLAIMS THAT THIS ALLOCATION SHOULD NOT BE
11 MADE WHEN CALCULATING THE TSLRIC COSTS OF INTRASTATE SERVICES.
12 PLEASE RESPOND.

13 A. First of all, as discussed in both my Direct testimony and in this Surrebuttal testimony, the
14 properly calculated TSLRIC costs do not include the loop facility costs. Therefore, there is no
15 valid issue of "allocating" the loop cost with respect to any TSLRIC cost study. Secondly, if the
16 rates for intrastate services are based upon costs that include 100% of the loop facility costs, the
17 result will be a double recovery of the interstate portion of the loop facility costs. This is true
18 because the 25% of the loop costs that is allocated to the interstate jurisdiction is recovered in
19 interstate rates.
20

21 There is no valid reason to consider 100% of the loop facility costs when analyzing the costs of
22 intrastate services. Since 25% of the costs of the loop are allocated to the interstate jurisdiction,
23 these costs do not even exist in the intrastate jurisdiction. Therefore, any measures of cost that

1 include 100% of the loop facility costs when only 75% of those costs even exist in the intrastate
2 jurisdiction will provide an unnecessary and unreasonably distorted view of the intrastate costs
3 of providing services. For these reasons Mr. Thompson's suggestion that 100% of the loop
4 facilities be included in costs calculations of intrastate services (whether those costs are TSLRIC
5 or other costs) should be rejected.

6
7 In addition, the intrastate portion of the loop facility costs (75% of the unseparated cost) is the
8 portion of the loop costs that must be recovered in the intrastate rates from all services that share
9 the loop, not just one of the intrastate services that share the loop (i.e. basic exchange service).

10 As discussed in my Direct Testimony and in this Surrebuttal, there are a number of intrastate
11 services that share the loop facilities, including toll, switched access, vertical services, ADSL
12 services as well as basic exchange services.

13
14 Q. ON PAGE 15 OF HIS REBUTTAL, MR. THOMPSON RESPONDS TO YOUR TESTIMONY
15 WHERE YOU LISTED A NUMBER OF COMMISSION ORDERS FROM VARIOUS
16 STATES BY CLAIMING THAT "WITH ONE EXCEPTION, WERE ALL RENDERED
17 PRIOR TO THE TELECOM ACT OF 1996". DID ANY OF THE COMMISSION ORDERS
18 YOU REFERENCED DEAL DIRECTLY WITH THE TELECOM ACT OF 1996?

19 A. Yes. One of the Commission orders I referenced was that of the Indiana Utility Regulatory
20 Commission (IURC), which is dated October 28, 1998. This Order specifically dealt with the
21 TA96, and specifically found that assigning 100% of the loop cost to one service would violate
22 Section 254(k) of TA96. It found that the loop was "included in the definition of common and
23 joint costs." The IURC found that,

1 For purposes of resolving 'takings' claims and 'a reasonable share of the joint and
2 common costs of facilities used to provide those services,' the loop must, therefore, be
3 included in the definition of common and joint costs in order to determine confiscation
4 claims and to be in compliance with the second sentence of Section 254(k). We find that
5 the direct assignment of 100% of the loop costs to any one service would be a violation
6 of the second sentence of Section 254(k).⁵² (Emphasis added)
7
8

9 The Indiana Order specifically found that assigning 100% of the costs to any one service (which
10 is what Qwest is proposing to do in this proceeding), is in direct violation of the TA96.
11

12 In fact, TA96 added an additional requirement that specifically requires that the rates for
13 universal service (which includes basic exchange service) may not include more than a
14 reasonable share of the joint and common costs.

15 (k) SUBSIDY OF COMPETITIVE SERVICES PROHIBITED.--A telecommunications carrier may
16 not use services that are not competitive to subsidize services that are subject to
17 competition. The Commission, with respect to interstate services, and the States, with
18 respect to intrastate services, shall establish any necessary cost allocation rules,
19 accounting safeguards, and guidelines to ensure that services included in the definition of
20 universal service bear no more than a reasonable share of the joint and common costs of
21 facilities used to provide those services.
22
23

24 **B. QWEST'S IDEA OF "ECONOMICALLY EFFICIENT" PRICING IS TO SHIFT**
25 **THE BURDEN OF SHARED/JOINT/COMMON COST RECOVERY FROM**
26 **COMPETITIVE SERVICES ONTO NON-COMPETITIVE SERVICES**
27

28 Q. ON PAGE 76 OF HIS REBUTTAL, DR. TAYLOR RECOMMENDS USING "RAMSEY
29 PRICING" PRINCIPLES TO GUIDE SERVICE RATES IN THIS PROCEEDING. WHAT
30 DOES THIS MEAN?

⁵²Indiana Utility Regulatory Commission Order, Cause No. 40785, Section V.(C) Common and Joint Costs, Issued October 28, 1998.

1 A. Under Ramsey Pricing, those services with the most inelastic demand (i.e. monopoly services)
2 are forced to recover a greater share of the shared, joint and common costs of the firm so that
3 those services with more elastic demand (i.e. competitive services) contribute very little toward
4 the shared, joint and common costs of the firm. As Dr. Taylor indicates in footnote 68 on page
5 76 of his Rebuttal, "The elasticity of demand measures how sensitive customers are to changes in
6 prices." In general, if a service is "inelastic", that means that if you increase the rate for the
7 service, the total revenue that you receive will increase. Monopoly services are generally more
8 inelastic than competitive services. With competitive services, if the company raises prices, the
9 customers can go elsewhere. However, if the company has monopoly powers, the customers
10 cannot go elsewhere in response to a price increase. Well-known economist William J. Baumol
11 stated:

12 Where scale economies are present, marginal cost pricing will, as we know, not cover
13 total cost, and the Ramsey theorem suggests that the prices of products whose demands
14 are particularly inelastic should then be raised most substantially above marginal costs.
15 But, to paraphrase the comments of one federal administrative law judge whose decision
16 dealt with the issue,⁵³ this places the burden upon those customers who have no place else
17 to go, whose demands are inelastic because they have no real alternative.⁵⁴ (Emphasis
18 added)
19
20
21

22 Q. HAS THE FCC REJECTED THE USE OF RAMSEY PRICING PRINCIPLES?

23 A. Yes. In its Local Competition Order, the FCC specifically addressed and rejected the use of
24 Ramsey Pricing principles when it stated:

25 On the other hand, certain other allocation methods would not be reasonable. For
26 example, we conclude that an allocation methodology that relies exclusively on allocating
27 common costs in inverse proportion to the sensitivity of demand for various network
28 elements may not be used. We conclude that such an allocation could unreasonably limit
29 the extent of entry into local exchange markets by allocating more costs to, and thus

⁵³See the decision of Judge Kraushaar in FCC Docket 19129 Phase II, August 2, 1976.

⁵⁴W.J. Baumol, Superfairness, Cambridge, MA: MIT Press, 1986, p.4.

1 raising the prices of, the most critical bottleneck inputs, the demand for which tends to be
2 relatively inelastic. Such an allocation of these costs would undermine the pro-
3 competitive objectives of the 1996 Act.⁵⁵
4
5

6 "Ramsey Pricing" is simply a different name for the concept of charging customers higher rates
7 whenever a company can do so, because it has monopoly power over them. Referring to those
8 customers who simply have nowhere else to turn as more "inelastic" customers, instead of
9 calling them "monopoly" customers does not change the concept.

10
11
12 Q. WHAT IS WRONG WITH THE COMPANY CHARGING MORE WHERE IT HAS
13 MONOPOLY POWER THAN IT WOULD CHARGE IF IT DID NOT HAVE A MONOPOLY?

14 A. This is an abuse of monopoly power, plain and simple. One of the primary reasons regulation of
15 monopoly services exists is to prevent the companies from abusing that monopoly power. As I
16 discussed in my Direct Testimony, in the old days prior to the regulation of the railroad industry,
17 the three or four railroad companies would engage in cut-throat price competition for long haul
18 routes where competition existed. At the same time, for short-hauled trips where shippers had no
19 alternative, the railroads would jack up the rates to very high levels. This discriminatory
20 pattern of rates is one thing that led to the establishment of the Interstate Commerce Commission
21 to regulate the railroad industry.⁵⁶
22

23 Q. COULD YOU GIVE US SOME REAL WORLD EXAMPLES OF WHY ALLOWING
24 RAMSEY PRICING IS NOT IN THE PUBLIC INTEREST?

⁵⁵FCC Local Competition Order, 96-325 at ¶1696.

⁵⁶Dunkel Direct, page 6.

1 A. Yes. If there was only one taxicab around, and you were in a hurry to make an important plane
2 connection, or to go to the hospital to have a baby, that taxicab ride might cost you several
3 hundred dollars under Ramsey pricing. Under Ramsey pricing, when a customer's demand is
4 inelastic (or in other words when they have no choice), the price must be set high.

5
6 As another example, if someone who was near death from lack of water stumbled in out of the
7 desert into a convenience store that was the only possible source of water, the proper Ramsey
8 pricing for a bottle of water (which normally retailed for \$1.00) would be very high (i.e.
9 \$100,000). That would be correct Ramsey pricing, because in this case the customer's demand
10 would be highly inelastic, and Ramsey Pricing dictates that the more inelastic the demand, the
11 higher the price.

12
13 Ramsey pricing, in effect, says that companies should charge more to customers who have no
14 choice. The more monopoly power that the company has over the customer, and the more the
15 customer needs the service, the more the company should charge them. This same principle,
16 throughout the decades, has gone by names other than Ramsey pricing. "Price gouging" and
17 "abuse of monopoly power" are examples.

18
19 It is well established that abuse of monopoly power, price gouging, and Ramsey Pricing, all of
20 which are effectively the same thing, are contrary to the public interest. Therefore, this
21 Commission should reject that concept.

1 **C. COMPETITIVE ZONES**

2
3 Q. ON PAGE 10 OF HIS REBUTTAL, MR. TEITZEL CLAIMS THAT QWEST'S
4 COMPETITIVE ZONE PROPOSAL "COMPLIES COMPLETELY WITH COMMISSION
5 RULES." DOES THE QWEST PROPOSAL COMPLY WITH ARTICLE 11, SECTION R14-
6 2-1108 (B) OF THE COMMISSION'S RULES?

7 A. No. Under Mr. Teitzel's proposed "competitive zone" regulatory structure, the information that
8 the Commission's rules require would not be required to classify a wire center as a "competitive
9 zone." As discussed on page 14 of my Direct, under the Qwest proposal, any wire center where
10 any competitor, including a reseller, is offering even one residential service would result in all
11 residential services being classified as a "competitive zone." Under Qwest's proposal, Qwest
12 would not be required to show any indications of market power, provide the estimated market
13 share, provide a description of the general economic conditions in the relevant market that make
14 the service competitive, or provide most of the other information that are properly required by
15 the current Commission rules in order to determine if effective competition exists.

16
17
18 Q. ON PAGE 12 OF YOUR DIRECT, YOU POINTED OUT THAT MR. TEITZEL'S PROPOSAL
19 ON PAGE 3 OF HIS REBUTTAL, MR. TEITZEL CLAIMS THAT PRICES FOR
20 REGULATED SERVICES OUTSIDE OF "COMPETITIVE ZONES" WILL CONTINUE TO
21 BE SET BY THE COMMISSION, THEREFORE QWEST WOULD NOT BE ALLOWED TO
22 INCREASE RATES WHERE EFFECTIVE COMPETITION DOES NOT EXIST. WOULD
23 QWEST'S "COMPETITIVE ZONE" PROPOSAL ALLOW QWEST TO INCREASE RATES
24 WHERE EFFECTIVE COMPETITION DOES NOT EXIST?

1 A. Absolutely. The reason for this is simple - under Qwest's "competitive zone" proposal, effective
2 competition need not exist in a wire center in order for it to be established as a "competitive
3 zone." As I discussed on pages 11-12 of my direct testimony in this proceeding, even if a
4 competitor offers only one residential service in a wire center, then all of the residential services
5 could be deemed competitive in that wire center, even if there is no competitor actually
6 providing the other residential services in that wire center. Likewise, if a competitor offers even
7 one business service in that zone, then all business services could be deemed competitive in that
8 zone.

9
10 The Qwest "competitive zone" proposal is crafted such that all Qwest must do is demonstrate
11 that at least one company is at least offering one service that is competing with a Qwest service
12 offering. After that, Qwest would be granted pricing flexibility on all services in that category
13 (residential or business), even if there is no alternative provider even offering those other
14 services. As discussed on page 14 of my direct testimony, no indication of market power,
15 market share or other information that indicates effective competition actually exists, would be
16 required. Quite simply, Qwest would be allowed to declare areas as "competitive" even where
17 there was no effective price constraining competition.

18
19 Q. ABOVE YOU INDICATED THAT QWEST'S "COMPETITIVE ZONE" PROPOSAL IS
20 WRITTEN SUCH THAT A COMPETITOR OFFERING A SINGLE SERVICE IN A WIRE
21 CENTER COULD POTENTIALLY TRIGGER THE ESTABLISHMENT OF THAT WIRE
22 CENTER AS A "COMPETITIVE ZONE." DID QWEST RESPOND TO THIS CRITICISM IN
23 ITS REBUTTAL TESTIMONY?

1 A. Yes. Similar criticisms of the Qwest "competitive zone" proposal were advanced by a number of
2 parties in this proceeding.⁵⁷ In his Rebuttal, Mr. Teitzel stated:

3 For expansion of competitive zones in the future, Qwest would be required to notify the
4 Commission that competition exists in the form of at least one of the three criteria
5 specified in my Direct testimony in a particular wire center. This notification would
6 certainly have to pass the "red face" test. It would be based on much stronger evidence
7 than a competitor serving one customer in a wire center. That is not even reasonable.⁵⁸
8
9

10 I agree with Mr. Teitzel that it "is not even reasonable" that Qwest would be allowed to establish
11 a wire center as a competitive zone if a competitor were serving only one customer in a wire
12 center. However, that unreasonable rule is exactly what Qwest is proposing. Once such an
13 unreasonable rule is in place, Qwest could implement that rule.
14

15 Q. ON PAGE 9 OF HIS REBUTTAL, MR. TEITZEL CLAIMS THAT THE COMMISSION
16 SHOULD "REST ASSURED" THAT QWEST'S REQUESTS TO CLASSIFY WIRE
17 CENTERS AS "COMPETITIVE ZONES" WOULD BE SUPPORTED BY "MUCH MORE
18 ROBUST" EVIDENCE OF COMPETITION THAN YOUR "EXTREME" EXAMPLE.
19 PLEASE COMMENT.

20 A. Once the rules are in place, there would be no valid basis to effectively challenge Qwest's
21 utilization of those rules. The time to stop an improper rule is when it is proposed, not later
22 when Qwest is making changes which are improper, but which are allowed by that rule. I urge
23 the Commission not to adopt improper rules. Qwest is attempting to have the rules set very lax,
24 but assure the Commission that those lax rules are meaningless, because supposedly Qwest
25 would not fully implement them. Obviously, rules that do not provide the proper guidelines

⁵⁷See Dunkel (Staff) Direct Testimony page 1, line 10, Selwyn (AT&T) Direct Testimony, page 22, line 1, Johnson (RUCO) Direct Testimony, page 24.

1 should not be adopted. Adopting improper rules based upon Qwest's assurance that it does not
2 "intend" to actually utilize those rules, or utilize them to the full, possible extent, is improper.

3
4 In addition, once the rules are in place, the "intentions" can change. In the future, Qwest could
5 simply declare that "conditions" have changed, and therefore they are going to implement the
6 rules.

7
8 If a business personal verbally promised one thing, but asked you to sign a written contract
9 saying something different, the wise consumer would insist that the written contract reflect the
10 "verbal understanding." The same is true in this case.

11
12
13 Q. MR. TEITZEL HAS FOCUSED ON THE FACT THAT YOU AND OTHER PARTIES
14 REFERRED TO "ONE" CUSTOMER SERVED BY A COMPETITOR OR "ONE" SERVICE
15 BEING OFFERED BY A COMPETITOR AS BEING AN UNREASONABLE STANDARD
16 FOR CLASSIFYING A WIRE CENTER AS A COMPETITIVE ZONE. PLEASE
17 COMMENT.

18 A. The point is, the requirements that Qwest has proposed in order to have a service classified as a
19 "competitive zone" are almost trivial requirements that do not require the demonstration of
20 effective competition, or effective competition for all of the services that would be classified as
21 competition.

⁵⁸Teitzel Rebuttal Testimony, page 43, line 18.

1 Q. ON PAGE 58 OF HIS REBUTTAL, MR. TEITZEL PROVIDES AN EXAMPLE TO
2 DEMONSTRATE THAT RESALE "IS MUCH MORE PREVALENT IN PHOENIX AND
3 TUCSON EXCHANGES THAN IT IS IN THE REST OF THE STATE." WHAT DOES MR.
4 TEITZEL'S EXAMPLE ACTUALLY DEMONSTRATE?

5 A. Mr. Teitzel provided the following example in his Rebuttal:

6 This data shows that resale, just one indicator of a competitive market, is extremely more
7 prevalent in Phoenix and Tucson exchanges than it is in the rest of the state. For
8 example, there were ** ** residence access lines resold in Bisbee, contrasted to ** **
9 residence access lines resold out of the Chandler Main wire center during this time
10 period.
11

12
13 What Mr. Teitzel's example demonstrates is the tiny amount of resale competition in these two
14 wire centers at this time.⁵⁹ The fact that resale in the Bisbee wire center was even closer to non-
15 existent than it was in the Chandler-Main wire center does not prove that meaningful competition
16 exists in the Chandler-Main wire center.
17

18 Q. ON PAGE 5 OF HIS REBUTTAL, MR. TEITZEL ARGUES THAT BY CHARGING A
19 LOWER RATE FOR RESIDENTIAL BASIC EXCHANGE SERVICE THAN QWEST DOES,
20 COX HAS "USED THE REGULATORY CONSTRAINTS QWEST MUST ADHERE TO IN
21 ORDER TO FURTHER THEIR MARKETPLACE ADVANTAGE." DO YOU BELIEVE
22 THAT COX HAS A "MARKETPLACE ADVANTAGE" OVER QWEST?

23 A. No, exactly the opposite. Qwest has the "marketplace advantage" of starting out by serving all of
24 the customers. Competitors like Cox have to actually lure customers away from Qwest to
25 become their service provider. Therefore, it is not surprising that a competitor would have to

1 offer a lower price than Qwest in order to lure the customer away. If a competitor offered a
2 higher price than Qwest, or were to simply match the price charged by Qwest, there would be no
3 price advantage to cause customers to change service providers. Therefore, the competitor is at a
4 clear market disadvantage compared to Qwest. In order to lure customers away from Qwest,
5 competitors have to charge lower prices or offer some other advantage over Qwest.

6
7 Q. ON PAGE 6 OF HIS REBUTTAL, MR. TEITZEL ARGUES THAT YOU HAVE NOT
8 PROVIDED ANY "FACTUAL SUPPORT" FOR YOUR TESTIMONY AT PAGE 9 OF YOUR
9 DIRECT, THAT QWEST'S "COMPETITIVE ZONE" PROPOSAL WOULD PROVIDE
10 QWEST WITH THE OPPORTUNITY TO HELP ASSURE THAT COMPETITORS WERE
11 NOT SUCCESSFUL. IN YOUR TESTIMONY, DID YOU SPECIFICALLY EXPLAIN HOW
12 THIS COULD OCCUR IF QWEST'S PROPOSAL IS ADOPTED?

13 A. Yes. Not only did I explain how Qwest's proposal would allow Qwest to use its pricing
14 flexibility to discriminatory price services to disadvantage its competitors, I provided a specific
15 example of how Qwest could implement such a strategy in the limited geographic areas where
16 Cox is providing competing telecommunications services in Arizona. On page 9 of my Rate
17 Design Direct, I pointed out that in the limited areas where it offers services, Cox
18 Communications offers residential basic exchange service at \$11.75 per month to its cable
19 subscribers (and at \$13.00 per month to its non-cable subscribers). Therefore, Qwest's current
20 rate of \$13.18 is already 12% higher than the \$11.75 rate being offered by Cox. Under the

⁵⁹For example, according to Qwest's response to Request WDA 37-001, Attachment A, the total number of lines in the Bisbee wire center was ** ** and the total number of lines in the Chandler-Main wire center was ** ** for this same period.

1 Qwest "competitive zone" proposal, Qwest could choose to underprice Cox or remove any Cox
2 pricing advantage in those zones in which Cox competes.

3
4 In fact, as discussed in the prior question, on page 5 of his Rebuttal, Mr. Teitzel is complaining
5 that "regulatory constraints" on Qwest are apparently preventing Qwest from lowering its price
6 to compete with Cox. The "competitive zone" strategy would allow Qwest to do this in those
7 areas where Cox was a competitor, while Qwest would not have to also lower rates, or could
8 even raise rates, in areas where Cox or similar competition did not exist. This type of
9 discrimination impedes competition, and would also result in the extraction of monopoly profits
10 in areas where the Company has an effective monopoly.

11
12 In the other so-called "competitive zone" wire centers, where Cox or an equivalent competitor
13 was not providing competing residential basic exchange services, Qwest could charge any
14 residential basic exchange rate it wanted to, up to a maximum of \$19.00.⁶⁰

15
16 Q. IN HIS REBUTTAL, MR. TEITZEL DISCUSSES THE "COMPETITIVE ZONE"
17 REGULATION THAT QWEST IS OPERATING UNDER IN THE STATE OF OREGON.⁶¹ IS
18 THE "COMPETITIVE ZONE" PRICE STRUCTURE IN OREGON THE SAME AS THE
19 COMPETITIVE ZONE REGULATION QWEST IS SEEKING IN THIS PROCEEDING?

20 A. No. The Oregon "competitive zone" regulation states that the rates for competitive zone services
21 cannot be lower than the total service long run incremental costs of providing the services, and
22 the rates cannot be higher than the tariff rates that were in effect when the competitive zones

⁶⁰Teitzel Direct Testimony, page 18.

⁶¹Teitzel Rebuttal Testimony, p.6 and pp. 34-35.

1 were established, unless authorized by the commission. In response to Data Request WDA 24-6
2 in this proceeding, Qwest provided a copy of the Oregon competitive zone regulation statute.

3 The Oregon "competitive zone" statute reads as follows:

4 The price and terms of service offered by a telecommunications utility for a competitive
5 zone service within a competitive zone may differ from that outside the zone. However,
6 the price for a competitive zone service within the zone may not be lower than the total
7 service long run incremental cost, for nonessential functions, of providing the service
8 within the zone and the charges for essential functions used in providing the service, but
9 the commission may establish rate for residential local exchange telecommunications
10 service at any level necessary to achieve the commission's universal service objectives.
11 Within the zone, the price of a competitive zone service, or any essential function used in
12 providing the competitive zone service, may not be higher than those prices in effect
13 when the competitive zone was established, unless authorized by the commission.⁶²
14 (Emphasis added)

15
16
17
18 The Qwest "competitive zone" proposal in this proceeding differs from the Oregon competitive
19 zone service regulation in two key respects, in that Qwest is requesting that the minimum prices
20 for services could be below the total service long run incremental cost⁶³, and the maximum
21 prices for service could be up to double the prices that are in effect when the competitive zone is
22 established (up to \$19.00 for residential basic exchange service), without specific formal
23 Commission approval.⁶⁴

24
25 Q. ON PAGE 44 OF HIS REBUTTAL, MR. TEITZEL CLAIMS "QWEST WILL CONTINUE TO
26 ADHERE TO EXISTING RULES PROHIBITING CROSS-SUBSIDIZATION IF
27 COMPETITIVE ZONES ARE GRANTED." DOES QWEST'S PROPOSED PRICE FLOOR
28 FOR COMPETITIVE ZONE SERVICES "ADHERE TO EXISTING RULES PROHIBITING
29 SUBSIDIZATION?"

⁶²Oregon Statute, ORS 759.050 (5)(b).

⁶³Teitzel Direct, page 20, lines 7-9.

1 A. No. The rule that Mr. Teitzel is referring to is ACC Rule R 14-2-1109 (c).⁶⁵ This rule
2 specifically requires that each competitive telecommunications service must be priced equal to or
3 above the TSLRIC of that service. This rule states as follows:

4 R14-2-1109 (c) No Cross-Subsidization.

5
6 A competitive telecommunications service shall not be subsidized by any rate or charge
7 for any noncompetitive telecommunications service(s). To insure that no cross-
8 subsidization exists, each competitive telecommunications service must provide revenues
9 that equal or exceed the company's total service long-run incremental cost of providing
10 the service. (Emphasis added)
11

12
13 Contrary to the ACC's rule quoted above, the Qwest "competitive zone" proposal would allow
14 Qwest to price competitive services below the TSLRIC of providing the service. Mr. Teitzel
15 described Qwest's proposal in his Direct Testimony in this proceeding:

16
17 Prices for specific services may be offered below Total Service Long Run Incremental
18 Cost (TSLRIC) in a competitive zone only as long as the total revenue for the customer
19 or group of customers is above TSLRIC.⁶⁶ (Emphasis added)
20

21
22 Since Qwest is proposing to be allowed to price services below TSLRIC in a competitive zone,
23 Qwest's proposal is not consistent with the ACC rule that Mr. Teitzel claims Qwest will adhere
24 to if the "competitive zone" proposal is granted. Nothing in the Commission's rule indicates that
25 pricing a competitive service below TSLRIC is permissible "as long as the total revenue for the
26 customer or group of customers is above TSLRIC."
27

28 Q. MR. TEITZEL STATES,

29 I proposed the price cap (doubling existing or proposed rates) as a means of addressing
30 Commission and consumer concern about potential price increases if the competitive

⁶⁴Teitzel Direct, page 20, lines 11-16.

⁶⁵See footnote 13 of Mr. Teitzel's Rebuttal Testimony.

⁶⁶Teitzel Direct Testimony, page 20, lines 7-9.

1 zone proposal is approved. It is not Qwest's intent to increase rates to the identified price
2 caps - again, market forces will best determine appropriate prices - but the caps will
3 provide an outside limit for any future price increases.
4

5 SHOULD THIS COMMISSION ADOPT QWEST'S PROPOSAL BASED UPON MR.

6 TEITZEL'S PLEDGE THAT QWEST DOES NOT "INTEND" TO DOUBLE THE RATES?

7 A. No. If the understanding is that Qwest does not "intend" to double the rates, then the logical way

8 to assure that intention is followed is to set the rules so that they cannot double the rates. If

9 Qwest is not intending to take advantage of this requirement, then failing to pass that

10 requirement would not harm Qwest (since they are not going to use it anyway), but it would

11 certainly alleviate the valid concern of the consumers that such an expanded price cap would

12 create. Further, "intentions" can subsequently change, and often times do. In the future, the

13 company could raise prices and simply explain that "conditions" had changed since this "intent"

14 was previously expressed. The fact is that if Qwest's proposal is adopted, Qwest would be able

15 to double its service rates, and would be in full compliance with its tariff by doing so. As

16 discussed in my Rate Design Direct testimony, many of the customers within the "competitive

17 zone" areas proposed by Qwest would actually have no effective choice of service provider, and

18 therefore Qwest's potential "doubling" of the rates is even more troubling.⁶⁷
19

20 Q. ON PAGE 4 OF HIS REBUTTAL, MR. TEITZEL CLAIMS THAT HE IS "UNCLEAR AS TO

21 WHAT MR. DUNKEL'S POSITION IS RELATIVE TO THE EFFECT COMPETITIVE

22 ZONES WILL HAVE ON COMPETITION." MR. TEITZEL STATES "ON ONE HAND, IT

23 APPEARS HE IS CONCERNED THE COMPANY WILL RESPOND TO COMPETITION BY

24 LOWERING RATES AND ON THE OTHER HAND, HE FEARS THE COMPANY WILL

25 INCREASE RATES." PLEASE RESPOND.

1 A. Mr. Teitzel is correct. I have concerns with the fact that Qwest's "competitive zone" proposal
2 would provide Qwest with both the ability to reduce rates for the geographic areas or for the
3 services that are subject to greater competition and the ability to greatly increase the rates or for
4 the services that are subject to less competition. For example, in the so-called competitive zone"
5 wire centers where a facilities-based provider like Cox is providing competing residential basic
6 exchange service, Qwest could greatly reduce the residential basic exchange rates in order to
7 disadvantage Cox, and harm the development of competition. At the same time Qwest could
8 greatly increase the rates for residential basic exchange service in the so-called "competitive
9 zone" wire centers where there are no facilities-based competitors operating (e.g. competition is
10 limited to resale competition). The price discrimination that the zone proposal would allow
11 could be the worst of both worlds for the public interest. It would allow Qwest to impede
12 competition by lowering prices where competition does exist, while at the same time extracting
13 monopoly profits elsewhere.

14
15 Q. ON PAGE 12 OF HIS REBUTTAL, MR. TEITZEL ARGUES THAT COMPETITION USING
16 RESALE AND UNBUNDLED NETWORK ELEMENTS SHOULD BE CONSIDERED
17 EFFECTIVE COMPETITION. IS COMPETITION USING RESALE AND UNBUNDLED
18 NETWORK ELEMENTS REALLY EFFECTIVE COMPETITION?

19 A. No. As I discussed beginning on page 15 of my Direct Testimony, resellers resell services that
20 are provided by Qwest. The wholesale rate the resellers pay to Qwest represents the resellers'
21 major cost of doing business. Since Qwest's retail rates are simply a function of Qwest's retail
22 rates (residential wholesale rates are discounted 12% off retail rates and business rates are
23 discounted 18%), if Qwest increases its retail rates, the wholesale rates the resellers must pay

⁶⁷Dunkel Direct Rate Design testimony, Page 32 and pages 12-23.

1 Qwest increases by the same percent. If a hypothetical LEC were to double its retail service
2 rates, that would result in the wholesale rates also doubling. Under these conditions, the cost that
3 makes up approximately 88% of the resellers' cost of doing business (i.e. the wholesale rate it
4 must pay the LEC), would automatically double when the LEC doubled its retail rate, therefore
5 the reseller would have no real choice but to follow the LEC's lead by increasing rates it charges
6 consumers. Due to the fact that a reseller's cost of doing business depends so greatly on what
7 retail rates the LEC charges, the availability of resellers cannot provide customers with any
8 significant protection from improper price increases by the LEC.

9
10 Q. ON PAGE 48 OF HIS REBUTTAL, DR. TAYLOR STATES:

11 Thus, in time as a reseller or UNE-user takes enough customers away from Qwest for it
12 to be able to deploy its own facilities and provide its own services, Qwest's loss from
13 losing a customer will include not merely the spread between retail and wholesale
14 revenues associated with the access line but also all other service revenues and
15 contribution that previously accrued from that customer.

16
17 PLEASE RESPOND.

18 A. In time, it is possible that resellers could potentially gain a large enough customer base to justify
19 deploying facilities that may ultimately lead to some price-constraining effective competition to
20 Qwest in Arizona. However, the fact is that the presence of competition in Arizona is just
21 beginning. For those services which are not "competitive" under the ACC Rules, there does not
22 yet exist sufficient price-constraining effective competition that would protect customers from
23 improper rate increases. In fact, Qwest's "competitive zone" proposal would give Qwest greater
24 flexibility to limit the growth of competition through pricing that discriminates based solely on
25 the level of competition, as previously discussed. Therefore, it would be improper to allow

1 Qwest to implement its "competitive zone" proposal on the basis of the limited competition that
2 exists today in Arizona.

3
4
5 Q. ON PAGE 9 OF HIS REBUTTAL, MR. TEITZEL STATES,

6 In addition, the wire centers identified in my direct testimony as possessing a sufficient
7 degree of competition to warrant classification as competitive zones all have a large
8 number of customers currently being served by facilities-based alternative providers.
9

10
11 DO THE WIRE CENTERS THAT QWEST PROPOSES BE MADE "COMPETITIVE ZONES"
12 HAVE A LARGE NUMBER OF CUSTOMERS BEING SERVED BY FACILITIES-BASED
13 PROVIDERS?

14 A. No. As shown on my direct testimony Schedule WDA-16, a mere ** ** of the residence lines
15 in the 23 wire centers that Qwest proposes be classified as residential "competitive zones" were
16 ported to CLECs as recently as April, 2000. For business, only ** ** of the total
17 business lines in the 49 wire centers that Qwest proposes be classified as business "competitive
18 zones" were "lost" to CLECs as of April, 2000, and there is no reason to believe that even all of
19 these were lost to "facility based" providers.⁶⁸ Therefore, the data in the record in this
20 proceeding clearly indicates that the very few of the customers in the wire centers that Qwest
21 proposes be classified as "competitive zones" are actually being served by competitors to Qwest.
22

23 Q. BEGINNING ON PAGE 41 OF HIS REBUTTAL, DR. TAYLOR POINTS OUT THAT IN
24 1995, WHEN AT&T WAS DECLARED A NON-DOMINANT CARRIER BY THE FCC, THE
25 HHI WAS 3,197 IN THE INTERSTATE LONG DISTANCE MARKET. PLEASE RESPOND.

⁶⁸As shown on Dunkel direct Schedule WDA-16, only ** ** of the total residential lines and only ** ** of the business lines in the "competitive zone" wire centers were resold lines. A mere ** ** of the Qwest residence and business lines in the "competitive zone" wire centers were sold as UNE loops.

1 A. In my Rate Design Direct testimony, I demonstrated that the residential wire centers which
2 Qwest proposes be immediately declared "competitive zones" have an HHI of over ** **⁶⁹
3 Thanks to the estimate provided by Dr. Taylor, we now know that the HHI market concentration
4 index in the wire centers which Qwest proposes be immediately declared as "competitive zones"
5 is nearly ** ** the HHI market concentration index in the interstate long distance
6 market when the FCC declared AT&T as a non-dominant carrier.

7
8 It is clear that the level of competitiveness for basic exchange service in these exchanges is
9 nowhere near the level of competition that must exist for a market to reasonably be considered
10 competitive, even using the standard that Dr. Taylor himself presented.

11
12 **D. HIGHER TOLL REVENUES IN RURAL AREAS ACT TO OFFSET THE**
13 **HIGHER COSTS OF SHARED FACILITIES IN RURAL AREAS.**
14

15 Q. ON PAGE 22 OF HIS REBUTTAL, MR. TEITZEL CLAIMS THAT UNLESS ZONE
16 INCREMENT CHARGES THAT APPLY TO BASIC EXCHANGE SERVICE ARE
17 INCREASED TO REFLECT THE HIGHER UNE LOOP RATES IN RURAL AREAS
18 RESULTING FROM DE-AVERAGING, COMPETITORS WILL BE DRIVEN AWAY FROM
19 SERVING RURAL AREAS. PLEASE COMMENT.

20 A. As I discussed on pages 73-77 of my Rate Design Direct testimony in this proceeding, Qwest's
21 arguments are based on the faulty premise that the loop cost (as identified by the UNE loop
22 rates) is directly a cost of only basic exchange service. On my direct testimony Schedule WDA-
23 17, I graphically demonstrated the fallacy of Qwest's premise. As shown on Schedule WDA-17,
24 the loop facilities are used by and are required to provide a whole family of services. Therefore,

⁶⁹Dunkel Direct, page 19, line 18.

1 the UNE loop costs are not directly related to just the basic exchange service rates. In addition,
2 twenty-five percent of the loop costs are separated to the interstate jurisdiction. In any areas
3 where the loop costs are higher, that means the dollar amount per loop allocated to the interstate
4 jurisdiction is higher than in other areas where the loop cost is lower. The intrastate costs that
5 remain are recovered across the entire family of intrastate services that share the loop facilities,
6 not just one of the services (basic exchange service) that shares the loop facilities.

7
8 Q. IN YOUR DIRECT TESTIMONY, YOU DEMONSTRATED THE FACT THAT THE PER-
9 LINE INTRASTATE REVENUES ARE ALREADY MUCH HIGHER IN RURAL AREAS
10 THAN IN URBAN AREAS, PRIMARILY BECAUSE RURAL CUSTOMERS HAVE
11 HIGHER LEVELS OF TOLL AND SWITCHED ACCESS. DOES YOUR TESTIMONY ON
12 THIS ISSUE REBUT MR. TEITZEL'S CLAIM THAT THE ZONE INCREMENT CHARGES
13 MUST BE INCREASED TO PREVENT COMPETITORS FROM BEING DRIVEN AWAY
14 FROM SERVING RURAL AREAS?

15 A. Yes. As I discussed beginning on page 74 of my Rate Design Direct testimony, rural customers
16 generally have a more limited local calling area than do urban customers. The result of this fact
17 is that rural customers pay toll rates for calls which an urban customer pays local rates.

18
19 In my Rate Design Direct testimony (pages 75-77), I provided the percent of the total intrastate
20 minutes that are intrastate toll and switched access in the urban "Phoenix Main" wire center, and
21 compared that data to the percent of the total intrastate minutes that are intrastate toll and
22 switched access in the rural Whitlow, Payson and Casa Grande wire centers.

1		Urban		Rural		Rural		Rural
2		"Phoenix Main"		Whitlow		Payson		Casa Grande
3		<u>Wire Center</u>		<u>Wire Center</u>		<u>Wire Center</u>		<u>Wire Center</u>
4								
5	# Lines in Local			**	**	**	**	**
6	Calling Area							
7								
8	% of Intrastate	**	**	**	**	**	**	**
9	Minutes That are							
10	Toll/Access							
11								

12 It is not surprising that the average rural customers' toll bills are generally much higher than the
13 urban customers' toll bills. Since competitors have the opportunity to receive higher
14 toll/switched access revenues for rural customers compared to urban customers, this would offset
15 at least part of a higher UNE loop rate in rural areas. When a competitor is making the decision
16 whether or not to serve a particular areas or customer using the UNE loops, the rational
17 competitor will consider the total revenues from the whole package or family of services that the
18 competitor would receive from a customer (including the toll/switched access revenues), not just
19 the revenue it will receive from just basic exchange service. Even if the price of an unbundled
20 loop is higher in a more rural area as compared to an urban area, the competitors can expect to
21 receive higher intrastate toll and switched access revenues in those rural areas, thereby offsetting
22 some or all of the higher cost of serving those rural customers.

23

24 Q. ON PAGE 24 OF HIS REBUTTAL, MR. TEITZEL STATES "AT PAGE 81, MR. DUNKEL
25 ALLEGES THAT QWEST CAN EXPECT TO REALIZE AN INCREASE IN TOLL
26 REVENUES RESULTING FROM ITS PROPOSED DECREASE IN TOLL PRICES." DID
27 YOU MAKE THIS ALLEGATION IN YOUR TESTIMONY?

1 A. No. Mr. Teitzel has mis-understood (or mis-stated) my testimony. My testimony on this issue
2 focuses on the inconsistencies between Qwest's argument for the toll price reduction and Qwest's
3 revenue impact calculation for that reduction. Qwest's claimed basis for reducing intrastate toll
4 rates is that Qwest will be more successful in the toll market at the new lower rates than they
5 would be at the existing rates. This position effectively argues that although the prices would be
6 lower, the lower prices would attract more customers, and therefore, Qwest would be as well or
7 better off. However, this position is inconsistent with their revenue impact calculation.
8 According to Qwest's revenue calculation, the result of the proposed rate change would be a
9 reduction in the revenues received from intrastate toll services. One of the two following
10 conditions have to be true: (a) If it is true that Qwest will be better off in the toll market at the
11 lower price than at the current price, that means that Qwest will generate as much or more
12 revenues at the new rates than they would at the current rates. If this is true, then Qwest should
13 go ahead and lower its prices, but there is no revenue reduction that results. (b) If Qwest truly
14 believes (as shown by its revenue impact calculation) that it will be worse off in the toll business
15 if it lowers its prices than if it does not lower its prices, then either it should not lower its toll
16 prices, or if it does, it should not expect the ratepayers for monopoly services to offset the
17 revenue loss that would result from the Company's decision to lower its toll prices.
18
19 Under either scenario (a) or (b) above, Qwest is not entitled to receive money from the monopoly
20 services in order to support a change in price in the competitive toll services.
21

22 Q. IF QWEST TRULY BELIEVES THAT IT WILL BE BETTER OFF IN THE INTRASTATE
23 TOLL MARKET AT ITS PROPOSED RATES THAT AT THE CURRENT RATES,

1 COULDN'T QWEST IMPLEMENT ITS PROPOSED RATES OUTSIDE OF THIS
2 PROCEEDING WITHOUT COMMISSION APPROVAL?

3 A. Yes. As I pointed out on page 80 of my Rate Design Direct testimony, the ACC has already
4 determined that Qwest's intrastate toll services are competitive, and afforded pricing flexibility.
5 In addition, Qwest has admitted that Qwest could make the proposed rate reductions outside of
6 this rate case without the Commission's approval. In response to discovery, Qwest stated:

7
8 With the pricing flexibility currently afforded toll services, U S WEST could certainly
9 reduce its toll rates outside of this rate case without Commission approval.⁷⁰
10
11

12 Since Qwest can already reduce its intrastate toll rates outside of this rate case and without
13 Commission approval, Qwest is actually seeking to increase the rates for non-competitive
14 services to fund its proposed rate reductions for a competitive service (i.e. intrastate toll).
15

16 Q. WOULD IT BE APPROPRIATE TO ALLOW QWEST TO INCREASE THE RATES FOR
17 NON-COMPETITIVE SERVICES TO FUND COMPETITIVE RATE REDUCTIONS?

18 A. No. Increasing the rates for non-competitive services to offset rate reductions for competitive
19 services runs counter to the whole concept of designating services as competitive. Once the
20 Qwest executives have been given substantial price flexibility for the competitive services, they
21 are the ones who should be managing the prices (within the specified limits).⁷¹ However, instead
22 of the Qwest executives managing their toll services, they are coming back to the Commission,
23 with their hat in their hand, asking the Commission to give them money to be raised from other
24 customers' rates, in order to support a lowering of the Qwest toll rates in the competitive toll

⁷⁰Qwest's response to data request WDA 2-21(b).

1 market. In the past, Qwest had asked for the ability to lower toll rates within limits without
2 Commission approval, and the Commission gave it that authority. If Qwest now thinks a toll rate
3 reduction is appropriate, it can do so without Commission approval. One of the key expected
4 benefits of competition is that customers will enjoy lower rates. That key intended benefit will
5 be lost if any rate reductions for competitive services are simply offset by increased rates for
6 non-competitive services.

7
8 **E. DIRECTORY ASSISTANCE**

9
10 Q. ON PAGE 88 OF YOUR DIRECT TESTIMONY, YOU INDICATED THAT QWEST
11 MISCALCULATED THE REVENUE IMPACT OF ITS DIRECTORY ASSISTANCE
12 PROPOSAL. ON PAGE 25 OF HIS REBUTTAL, MR. TEITZEL ARGUES THAT QWEST'S
13 REVENUE IMPACT IS ACCURATE. IS THE QWEST REVENUE IMPACT
14 CALCULATION ACCURATE?

15 A. No. From January through October 21, 1999, there was a 12 cent per call surcharge on the DA
16 rate. The total rate billed during that period was 59 cents per billed call. After October, the rate
17 reverted to its present rate of 47 cents per billed call. The problem with Qwest's calculation is
18 that Qwest has mishandled the surcharge revenues. Qwest has included the revenues from that
19 surcharge in the "present" revenues it used for its calculation. The difference between the Qwest
20 calculation and the correct calculation is shown below:

21
22
23

⁷¹ Those Commission-imposed limits are not at issue in this proposal, to the best of my knowledge.

Revenue Impact of Increasing the DA Rate
From 47 Cents (With One Call Allowance) To 85 Cents (With No Call Allowance)

	Correct Calculation		Qwest Calculation	
1. "Proposed" Revenue at 85 Cents (with no Call Allowance) using 1999 Quantities	**	** ⁷²	**	**
2. "Present" DA Revenue Received in 1999 from the 47 cent Rate (with One Call Allowance)	- **	**		
2a. "Present" Revenue at 59 Cents for Most of 1999 (including 12 cent surcharge)			- **	**
3. Revenue Loss from Providing Complete-A-Call at no Additional Charge	- **	**	- **	**
4. Increase from Change in Rate (and Change in Call Allowance)	**	**	**	**

This calculation is shown in more detail on Schedule WDA-31.

The "present" revenues Qwest is using are the revenues that were generated by a 59 cent rate applying most of the year, not the 47 cent present rate. Said another way, if the proposal was to increase the rates from 59 cents per billed call (with a one call allowance), to 85 cents per call, then the revenue impact Qwest presented would be approximately correct.⁷³ However, the proposed DA increase in this case is to increase the present rate, which is 47 cents (with a one call allowance), to 85 cents (with no call allowance). This has a larger revenue impact than Qwest has calculated. The revenue impact of the current proposal is \$23.1 million. Quite simply, Qwest has mishandled the impact of the revenues from the surcharge in this calculation.

⁷² This number is exactly as calculated by Qwest.

⁷³ Technically, it would be correct for 59 cents applying January through October 21, and then a 47 cent rate

1 **F. PRIVACY LISTINGS**

2
3 Q. ON PAGE 26 OF HIS REBUTTAL, MR. TEITZEL ARGUES THAT QWEST'S PROPOSED
4 RATE INCREASES FOR PRIVACY LISTINGS ARE APPROPRIATE BECAUSE THEY
5 ARE "DISCRETIONARY" SERVICES, SIMILAR TO CUSTOM CALLING SERVICES. DO
6 YOU AGREE?

7 A. No. As I indicated on page 91 of my Rate Design Direct testimony, an indeterminate number of
8 customers who subscribe to privacy listings have themselves been targets of harassment or
9 worse. These customers depend upon privacy listings for their own protection, and are therefore
10 customers of a captive market. Since these customers must pay whatever rate Qwest charges for
11 privacy listings to protect themselves from being targets of harassment, privacy listings are not
12 appropriately considered to be "discretionary" in nature. Rather, many subscribers to privacy
13 listings are captive ratepayers, who are inappropriate targets for extracting high levels of
14 contribution. As I indicated on page 90 of my direct testimony, according to the costs presented
15 in Mr. Thompson's Supplemental Direct Testimony Exhibit JLT-1, page 15, the cost to provide
16 Non-Published and Non-Listed privacy listing services is ** **. The current rates for Non-
17 Published Service (\$1.90 for residence and \$1.80 for business customers) and Non-Listed
18 Service (\$1.55 for residence customers and \$1.45 for business customers) are already providing
19 considerable contribution above their direct costs.⁷⁴

20
21
22
applying after that.

⁷⁴Teitzel Direct Testimony, page 58, line 16.

1 **G. CONTRARY TO MR. TEITZEL'S CLAIMS, TA96 REQUIRES AFFORDABLE**
2 **UNIVERSAL SERVICE FOR ALL CUSTOMERS**
3
4
5

6 Q. ON PAGE 26 OF HIS REBUTTAL, MR. TEITZEL CLAIMS THAT ENSURING THAT
7 BASIC EXCHANGE SERVICES ARE AFFORDABLE TO ALL CUSTOMERS "WAS A
8 VALID CONCEPT IN THE PAST", BUT "NO LONGER FITS IN THE POST-TA 1996
9 ENVIRONMENT." PLEASE RESPOND.

10 A. The TA96 sets forth the following specific requirements:

11 §254(b) Universal Service Principles.-- The Joint Board and the Commission shall base
12 policies for the preservation and advancement of universal service on the following
13 principles:

14 (1) QUALITY AND RATES.-- Quality services should be available at just,
15 reasonable, and affordable rates.
16
17

18 Therefore, contrary to Mr. Teitzel's claims, making universal service affordable for all not only
19 "fits in the post-TA 1996 environment", but it is a specific requirement in the TA96.
20

21 Q. MR. TEITZEL CLAIMS THAT YOU "SEEM TO DISMISS TARGETED ASSISTANCE
22 PLANS FOR CUSTOMERS WITH LIMITED MEANS."⁷⁵ DID YOU DISMISS THE
23 ASSISTANCE PLANS?

24 A. No. In my Rate Design Direct testimony, I acknowledged that these programs are helpful, but
25 that they are not the full answer to the promotion of universal service, since they target only very
26 narrowly defined groups of customers. On page 108 of my direct, I stated the following:

27 The fact is that programs like Lifeline and TAP, which provide assistance to low income
28 consumers are helpful, however, such need-based plans are not the full answer. Many of
29 the customers that would qualify for such programs, for a number of different reasons do
30 not receive assistance from these programs. For example, they may not be aware of these

⁷⁵Teitzel Rebuttal, page 26, line 18.

1 programs, may not be willing to go through the administrative procedures required to
2 qualify or may for personal reasons be unwilling to accept assistance on the basis of their
3 income.
4

5 In addition, in my direct, I pointed out that the total number of customers that subscribe to
6 Lifeline service in Arizona is 4,447 and the total number of subscribers who receive assistance
7 from the TAP program is 3,835⁷⁶, whereas Qwest disconnects over ** ** residential
8 customers per year for non-payment at current rates.⁷⁷ Based on these facts, it is clear that there
9 are many residential subscribers that are having trouble paying their bills at current rates, despite
10 the fact that Lifeline and TAP do help some subscribers.
11

12 **H. PRIVATE LINE**
13

14 Q. ON PAGE 13 OF HIS REBUTTAL, MR. MCINTYRE STATES "MR. DUNKEL, FOR THE
15 STAFF AGREES THAT PRIVATE LINE SERVICES ARE COMPETITIVE." DO YOU
16 HAVE ANY QUALIFYING REMARKS TO ADD TO THIS STATEMENT?

17 A. Yes. As pointed out on page 104 of my Rate Design Direct testimony, this Commission has
18 classified the interexchange private line services as competitive and flexibly priced. The
19 Commission has not classified local private line services as competitive or flexibly priced.
20 Therefore, I only agree that interexchange private line services are competitive and flexibly
21 priced in Arizona.
22

23 Q. ON PAGE 17 OF HIS REBUTTAL, MR. MCINTYRE REFERS TO YOUR PROPOSED
24 INCREASE FOR INTRASTATE PRIVATE LINES SERVICES WHEN HE STATES "MR.

⁷⁶Dunkel direct testimony, page 107, line 18.

1 DUNKEL ALSO SUGGESTS THAT SUCH AN INCREASE IN RATES MAY NOT BE
2 SUSTAINABLE IN A COMPETITIVE MARKET AND IT WOULD BE UP TO QWEST
3 MANAGEMENT TO DECIDE IF SUCH A RISK SHOULD BE TAKEN." DID YOU
4 SUGGEST THAT THE INCREASE IN RATES MAY NOT BE SUSTAINABLE?

5 A. No. This is simply a mis-statement of my testimony. In my direct testimony, I pointed out that
6 Qwest's intrastate private line services are currently being provided below cost, and that if Qwest
7 chooses to price its competitive services at a loss, that shortfall should not fall on non-
8 competitive services. The specific statements I made in my Rate Design Direct are as follows:

9 The revenue requirement that is being considered in this case includes in excess of **
10 ** in private line revenue requirement. However, the private line revenues are
11 only ** **. Therefore, if the rates are not increased, or a revenues imputation
12 is not made, that will mean that the rates for non-competitive services will have to be
13 priced to cover approximately ** ** of private line competitive service
14 revenue requirement. If USWC chooses to price its competitive services at a loss, that is
15 a USWC management decision which they are allowed to make under flexible pricing.
16 However, in no even should the rates for other non-competitive services be set to remove
17 the private line revenue requirement that the USWC management has elected to not
18 recover in the private line rates.⁷⁸
19

20 Q. IN YOUR TESTIMONY, YOU STATED THAT THE SPECIAL ACCESS BYPASS OF
21 SWITCHED ACCESS SERVICE WAS ECONOMICAL ONLY FOR HIGH USERS. MR.
22 MCINTYRE DISPUTES THIS, AND CLAIMS THAT SINCE A TYPICAL DS1 IS PRICED
23 ABOUT \$250 PER MONTH, "ANY CUSTOMER WHO GENERATES MORE THAN \$250
24 PER MONTH OF TOLL, AND MANY CUSTOMERS DO, IS AN EXCELLENT TARGET
25 FOR SUCH BYPASS."⁷⁹ IS MR. MCINTYRE'S CALCULATION VALID?

26 A. No. If such a customer paid \$250 for a special access line, that would not eliminate their toll bill.
27 They would still have to pay for toll, although slightly less, assuming the carrier passed on the

⁷⁷Dunkel direct testimony, page 108, line 19.

⁷⁸Dunkel Direct Testimony, page 105, lines 8-18.

1 switched access savings. In fact, as Mr. McIntyre stated on page 4 of his Rebuttal, the use of a
2 dedicated circuit does not eliminate the toll charges from the IXC's, but will only reduce them.

3 The carrier saves the switched access charges and passes some of these savings along to
4 the customer in the form of reduced toll charges.⁸⁰
5

6 The special access line would carry the call only from the customer premises to the IXC's point
7 of presence (POP). The customer would still have to pay the IXC toll rates to carry the call from
8 the POP to the other customer being called.
9

10 I will now take Mr. McIntyre's example of a customer paying \$250 per month in toll rates. If
11 that customer subscribed to a \$250 per month special access circuit, they would have to pay \$250
12 per month for the special access, and still have to pay the IXC for toll service, although it
13 presumably would be a figure that would be somewhat less than the \$250 per month toll bill they
14 had previously been paying. As a result, the customer's total bill would increase drastically.
15 Such a customer is not an "excellent target for such bypass."
16

17 Q. STARTING AT PAGE 16, LINE 5 OF HIS REBUTTAL, MR. WU STATES HE HAS
18 RECALCULATED THE DEPRECIATION RATE IN THE GENERAL PURPOSE
19 COMPUTER ACCOUNT. PLEASE COMMENT.

20 A. In this calculation, Mr. Wu adjusted the depreciation reserve for the claimed impact of Mr.
21 Brosch's disallowance of \$24 million of older investments. Mr. Wu alleges that removing those
22 investments would result in a much higher depreciation rate in the General Purpose Computer
23 account. This is not true for this account.
24

⁷⁹ Page 5, McIntyre Rebuttal.

1 First of all, in his figures, Mr. Wu was using the depreciation rates that were calculated by
2 applying the Commission approved parameters to the 1/1/97 investments and reserves. That is
3 not a valid calculation for the reasons discussed in my Direct Depreciation testimony.

4
5 In addition, the Company had the depreciation rates turned "off" for the General Purpose
6 Computer account for all of 1999.⁸⁰ Turning the account "off" means the Company did not
7 accrue a depreciation expense, and did not place the depreciation accruals in the depreciation
8 reserve for this account. The decision to turn the depreciation rates "off" is based upon an
9 analysis of the reserve level as compared to the requirement. Had the old investments been
10 previously retired, the reserve percent would have been lower, and the depreciation rates in this
11 account should have stayed "on" in early 1999. Even with the \$24 million removed, near the end
12 of 1999 the account still would have reached full recovery, and should have been switched "off"
13 late in 1999. Therefore, even with the \$24 million retired, the Account still would have been
14 "off" part of the time in 1999 to avoid over-recovery. Either way, by the end of 1999, the plant
15 should be virtually fully depreciated. In short, by 12/31/99, the depreciation rate in this account
16 would be the same either with or without the \$24 million having been retired prior to the
17 calculation. The only difference would be how long the account should have been "on" in 1999
18 before reaching full recovery.

19
20 I am addressing only the calculation of this depreciation rate for the General Purpose Computer
21 account. Any other questions relating to this issue should be referred to Mr. Brosch, and are not
22 being addressed in this testimony.

⁸⁰ Page 4, lines 20-22, McIntyre Rebuttal.

⁸¹ Qwest response to Request UTI 52-014, Attachment A, Note J.

1

2 Q. COULD YOU PLEASE BRIEFLY SUMMARIZE SOME OF YOUR MAJOR POSITIONS?

3 A. Yes. I recommend that the Modernization Accountability credit that I proposed in my Direct

4 Depreciation testimony be adopted. I recommend the depreciation rates shown on Schedule

5 WDA-29 be adopted. Those rates are properly calculated by applying the ACC approved

6 parameters to the 12/31/99 test year "per book" investments and reserves. In addition, the loop

7 facility is shared by several services. Therefore, Qwest's calculations which place the full cost of

8 the loop facility in the TSLRIC of just one of the services that shares that facility (basic

9 exchange service) are invalid. The contribution analysis contained in my Direct Rate Design

10 testimony is valid, and shows residential basic exchange service is not priced below its properly

11 calculated TSLRIC, and is producing a large contribution to the shared, joint, and common costs.

12

13 I recommend that these and other proposals contained in my Direct Depreciation and Rate

14 Design testimonies and in this testimony be implemented.

15

16 Q. DOES THIS CONCLUDE YOUR TESTIMONY?

17 A. Yes.

09/06/00
10:54 AM
XREF: 03
PRES: 1991,SF,02
PROP: 1997,SG,82

COMPANY: U S WEST
STATE: ARIZONA
ACCOUNT: 2421 AERIAL CABLE MET
CATEGORY: 2421 AERIAL CABLE MET
TABLE 2-VG/ELG

PROJECTION LIFE TABLE
AVERAGE SERVICE LIFE AND REMAINING LIFE BY AGE

PROJECTION LIFE TABLE PARAMETERS AVG LIFE 12.00

USING IOWA CURVE: R1.0

BEGINNING OF YEAR AGE	AMOUNT IN SERVICE	AMOUNT DURING YEAR (LIFE GROUP)	AGE OF AMOUNT RETIRE	ANNUAL ACCRUALS FOR BOY AGE A		ELG AVG.	ELG AVG.	VG
				EACH LIFE GROUP	FOR ALL REMAINING GROUPS	SER VICE LIFE	REMAIN ING LIFE	VINT REMAIN. LIFE
A	B	C=B-next B	D	E=C/D	F*	G=B/F	H=G-A	I#
0.0	100,000	1,100	0.5	2,199	15,292	6.54	6.54	12.00
0.5	98,901	2,389	1.0	2,389	13,093	7.55	7.05	11.63
1.5	96,512	2,637	2.0	1,319	10,705	9.02	7.52	10.91
2.5	93,875	2,881	3.0	960	9,386	10.00	7.50	10.20
3.5	90,994	3,123	4.0	781	8,426	10.80	7.30	9.51
4.5	87,871	3,392	5.0	678	7,645	11.49	6.99	8.83
5.5	84,479	3,717	6.0	620	6,967	12.13	6.63	8.16
6.5	80,762	4,098	7.0	585	6,347	12.72	6.22	7.51
7.5	76,664	4,522	8.0	565	5,762	13.31	5.81	6.89
8.5	72,142	4,969	9.0	552	5,197	13.88	5.38	6.29
9.5	67,173	5,414	10.0	541	4,644	14.46	4.96	5.72
10.5	61,759	5,822	11.0	529	4,103	15.05	4.55	5.18
11.5	55,937	6,164	12.0	514	3,574	15.65	4.15	4.66
12.5	49,773	6,408	13.0	493	3,060	16.26	3.76	4.18
13.5	43,365	6,521	14.0	466	2,567	16.89	3.39	3.72
14.5	36,845	6,477	15.0	432	2,101	17.53	3.03	3.29
15.5	30,367	6,256	16.0	391	1,670	18.19	2.69	2.89
16.5	24,111	5,846	17.0	344	1,279	18.86	2.36	2.51
17.5	18,265	5,246	18.0	291	935	19.54	2.04	2.15
18.5	13,019	4,466	19.0	235	643	20.24	1.74	1.81
19.5	8,554	3,544	20.0	177	408	20.95	1.45	1.50
20.5	5,010	2,534	21.0	121	231	21.68	1.18	1.21
21.5	2,476	1,552	22.0	71	110	22.41	0.91	0.93
22.5	925	785	23.0	34	40	23.15	0.65	0.65
23.5	139	139	24.0	6	6	24.00	0.50	0.50
TOTAL		100,000						

* F(AGE A) = SUM OF COL E AGE A TO END

I = 0.5 + ((SUM OF COL B FROM AGE A+1 THROUGH END)/(COL B AT AGE A))

Arizona
Docket No. T-1051B-99-105
WDA 21-001S1

INTERVENOR: Arizona Corporation Commission Staff (Dunkel)

REQUEST NO: 001S1

Please provide each of the following on an intrastate basis (not FCC) for each depreciable account:

A. Separately for December 31, 1998 and December 31, 1999, for each depreciable account please provide the complete generations arrangements on an intrastate basis not FCC basis. In addition to the paper copy, please also provide this requested information in electronic format on an IBM compatible 3.5" disk or an Iomega 100 MB Zip Disk.

B. For each depreciable account please provide the depreciation reserve balance as of December 31, 1998 and separately December 31, 1999.

C. For each depreciable account please provide the total retirements separately for 1998 and 1999.
Please provide each of the following on an intrastate basis (not FCC) for each depreciable account:

D. For each depreciable account please provide the retirements by vintage separately for 1998 and 1999. In addition to the paper copy, please also provide this requested information in electronic format on an IBM compatible 3.5" disk or an Iomega 100 MB Zip Disk.

E. For each depreciable account please provide the total additions separately for 1998 and 1999.

F. For each depreciable account please provide the plant in service as of December 31, 1998 and separately December 31, 1999.

RESPONSE:

A. On January 6, 2000 and April 25, 2000, the Commission decided upon depreciation parameters and lives to be used in Docket No. T-1051B-99-105. WDA 21-1, Part A requests generation arrangements which require completely new depreciation studies and are no longer relevant for this rate case. Therefore, generation arrangements have not been provided.

B. Please see Attachment D.

C. Please see Attachments A and B for the December 1998 and 1999 versions,

respectively, of the JR 2A report. The "Plant Retired" column displays the requested information. Totals only are reported, this information is not available on an intrastate basis.

D. Please see Confidential Attachment C for the 1998 and 1999 retirements by vintage.

E. Please see Attachments A and B for the December 1998 and 1999 versions, respectively, of the JR 2A report. The "Plant Added" column displays the requested information.

F. Please see Attachments A and B for the December 1998 and 1999 versions, respectively, of the JR 2A report. The "Total at End of Period" column displays the requested information.

Confidential Attachment C is being provided pursuant to the terms of the Protective Agreement.

Bill Muir
Technical Accountant
1600 17th Street, Rm. 3008
Seattle WA

Kathleen Tuttle
Manager - Capital Recovery
1314 DOTM
Omaha, NE

Supplemental Response 07/10/00

Attachments A-1 and A-2 contain the requested generation arrangement data for 1998 and 1999, respectively. Attachment B contains the generation arrangement data for both years in FCC electronic format.

Jim Jones
Manager - Capital Recovery
1801 California Street
Denver, CO 80202

07/06/00
02:55 PM
XREF: 07
PRES: 1991,SF,02
PROP: 2000,SA,02

COMPANY: U S WEST
STATE: ARIZONA
ACCOUNT: 2421 AERIAL CABLE MET
CATEGORY: 2421 AERIAL CABLE MET
TABLE 1-VG/ELG

GENERATION ARRANGEMENT
DEVELOPMENT OF AVERAGE REMAINING LIFE AND AVERAGE SERVICE LIFE

EXPERIENCE AS OF 1-1-2000%					REMAIN	VINT	AVERAGE	REMAINING
VINT	AGE	AMOUNT	PROP	REAL	ING	AVG	LIFE	LIFE
AGE	AGE	SURVIVING	SURV	LIFE	LIFE	LIFE	WEIGHTS	WEIGHTS
N	A	B	C	D	E++	F+++	G=B/F	H=E*G
*1999	0.5	7,438,539	0.9881	0.49	7.05	7.55	984,781	6,946,149
*1998	1.5	8,640,054	0.9944	1.49	7.52	9.02	958,330	7,202,558
*1997	2.5	9,892,832	0.9929	2.49	7.50	10.00	989,161	7,419,930
*1996	3.5	10,995,199	0.9931	3.49	7.30	10.80	1,018,146	7,431,689
*1995	4.5	8,596,955	0.9888	4.47	6.99	11.49	747,980	5,231,043
*1994	5.5	6,558,420	0.9793	5.44	6.63	12.13	540,859	3,583,696
*1993	6.5	6,477,742	0.9702	6.44	6.22	12.72	509,103	3,168,573
*1992	7.5	6,373,845	0.9796	7.42	5.81	13.31	479,041	2,781,037
*1991	8.5	7,232,374	0.9733	8.36	5.38	13.88	520,970	2,804,130
*1990	9.5	7,669,578	0.9656	9.32	4.96	14.46	530,293	2,631,794
*1989	10.5	6,854,258	0.9452	10.24	4.55	15.05	455,378	2,072,791
*1988	11.5	7,308,853	0.9381	11.16	4.15	15.65	466,965	1,938,759
*1987	12.5	6,286,802	0.9051	11.96	3.76	16.26	386,527	1,455,211
*1986	13.5	5,016,687	0.8950	12.66	3.39	16.89	296,992	1,007,297
*1985	14.5	4,831,397	0.8377	13.06	3.03	17.53	275,567	835,669
*1984	15.5	4,274,768	0.8509	14.10	2.69	18.19	235,039	631,667
*1983	16.5	3,808,911	0.8125	14.63	2.36	18.86	201,995	475,992
*1982	17.5	5,239,628	0.8413	15.80	2.04	19.54	268,157	546,879
1981	18.5	1,850,493	0.8316	17.14	1.81	18.64	99,258	180,027
1980	19.5	1,786,019	0.7262	16.46	1.50	17.55	101,756	152,592
1979	20.5	1,521,517	0.7089	17.56	1.21	18.42	82,609	99,680
1978	21.5	1,339,964	0.6622	17.78	0.93	18.40	72,840	67,712
1977	22.5	1,372,889	0.6640	19.16	0.65	19.59	70,091	45,609
1976	23.5	975,646	0.6792	20.55	0.50	20.89	46,710	23,355
1975	24.5	996,266	0.6405	20.47	0.50	20.79	47,914	23,957
1974	25.5	1,449,535	0.6189	20.95	0.50	21.26	68,191	34,096
1973	26.5	1,518,428	0.5911	21.26	0.50	21.55	70,454	35,227
1972	27.5	1,563,656	0.5848	21.43	0.50	21.72	71,995	35,997
1971	28.5	1,270,818	0.5584	22.34	0.50	22.62	56,191	28,096
1970	29.5	1,988,092	0.5960	23.94	0.50	24.24	82,028	41,014
1969	30.5	1,565,655	0.6097	24.86	0.50	25.16	62,218	31,109
1968	31.5	1,178,373	0.4908	23.87	0.50	24.12	48,859	24,430
1967	32.5	1,163,772	0.4658	24.39	0.50	24.62	47,268	23,634
1966	33.5	1,238,887	0.4936	25.49	0.50	25.74	48,128	24,064
1965	34.5	1,391,124	0.4823	26.44	0.50	26.68	52,137	26,069
1964	35.5	1,473,513	0.4458	25.59	0.50	25.81	57,091	28,546
1963	36.5	1,773,157	0.5027	27.64	0.50	27.89	63,581	31,790
1962	37.5	1,587,969	0.4642	27.87	0.50	28.11	56,499	28,249
1961	38.5	1,486,124	0.4513	28.10	0.50	28.32	52,472	26,236
1960	39.5	3,163,262	0.4636	29.96	0.50	30.19	104,778	52,389
1959	40.5	1,782,112	0.3712	28.02	0.50	28.21	63,177	31,588
1958	41.5	1,151,086	0.2871	27.34	0.50	27.48	41,889	20,944

07/06/00
02:55 PM
XREF: 07
PRES: 1991,SF,02
PROP: 2000,SA,02

COMPANY: U S WEST
STATE: ARIZONA
ACCOUNT: 2421 AERIAL CABLE MET
CATEGORY: 2421 AERIAL CABLE MET
TABLE 1-VG/ELG

Schedule WDA-26
Page 4 of 5

GENERATION ARRANGEMENT
DEVELOPMENT OF AVERAGE REMAINING LIFE AND AVERAGE SERVICE LIFE

EXPERIENCE AS OF 1-1-2000%					REMAIN	VINT	AVERAGE	REMAINING
VINT	AGE	AMOUNT	PROP	REAL	ING	AVG	LIFE	LIFE
AGE	AGE	SURVIVING	SURV	LIFE	LIFE	LIFE	WEIGHTS	WEIGHTS
N	A	B	C	D	E++	F+++	G=B/F	H=E*G
1957	42.5	665,039	0.2124	26.08	0.50	26.19	25,395	12,697
1956	43.5	512,245	0.1728	24.62	0.50	24.70	20,736	10,368
1955	44.5	642,523	0.1750	25.44	0.50	25.52	25,173	12,587
1954	45.5	542,122	0.1342	24.39	0.50	24.45	22,169	11,084
1953	46.5	330,081	0.0875	21.04	0.50	21.09	15,654	7,827
1952	47.5	180,205	0.0528	17.52	0.50	17.54	10,272	5,136
1951	48.5	94,915	0.0711	20.51	0.50	20.54	4,620	2,310
1950	49.5	59,299	0.0558	18.68	0.50	18.71	3,169	1,585
1949	50.5	46,079	0.0429	21.40	0.50	21.43	2,151	1,075
1948	51.5	22,216	0.0223	15.76	0.50	15.77	1,409	704
1947	52.5	8,726	0.0132	19.66	0.50	19.66	444	222
1946	53.5	7,333	0.0172	19.63	0.50	19.64	373	187
1945	54.5	568	0.0149	20.92	0.50	20.92	27	14
1944	55.5	1,858	0.0462	17.20	0.50	17.23	108	54
1943	56.5	1,922	0.0105	15.26	0.50	15.26	126	63
1942	57.5	16,376	0.0187	21.68	0.50	21.69	755	377
1941	58.5	16,748	0.0291	24.90	0.50	24.92	672	336
1940	59.5	7,412	0.0209	23.49	0.50	23.50	315	158
1939	60.5	6,897	0.0366	24.35	0.50	24.36	283	142
1938	61.5	3,470	0.0096	26.37	0.50	26.37	132	66
1937	62.5	2,605	0.0010	24.08	0.50	24.08	108	54
1936	63.5	4,983	0.0511	27.23	0.50	27.26	183	91
1935	64.5	5,522	0.0390	23.58	0.50	23.60	234	117
1934	65.5	2,069	0.0500	24.66	0.50	24.69	84	42
1933	66.5	1,575	0.0011	23.86	0.50	23.86	66	33
1932	67.5	1,180	0.0108	30.00	0.50	30.01	39	20
1931	68.5	1,707	0.0119	27.80	0.50	27.80	61	31
1930	69.5	2,582	0.0054	24.73	0.50	24.73	104	52
1929	70.5	14,345	0.0221	27.32	0.50	27.33	525	262
1928	71.5	10,188	0.0160	28.69	0.50	28.70	355	177
1927	72.5	5,767	0.0322	34.39	0.50	34.40	168	84
1926	73.5	5,596	0.0085	24.74	0.50	24.74	226	113
1925	74.5	1,212,663	0.0085	24.75	0.50	24.76	48,981	24,490
TOTAL		164,522,015					11,618,535	59,373,833
NON-ELG V		41,025,173					1,753,251	1,208,969
ELG V		123,496,842					9,865,284	58,164,864

AVG SERVICE LIFE:	ALL VINTS	NELG VINTS	ELG VINTS
TOT B/TOT G	14.16031	23.39948	12.51833
AVG REMAINING LIFE:	ALL VINTS	NELG VINTS	ELG VINTS
TOT H/TOT G	5.11027	0.68956	5.89591

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XREF: 07
PRES: 1991,SF,02
PROP: 2000,SA,02

Schedule WDA-26
Page 5 of 5
COMPANY: U S WEST
STATE: ARIZONA
ACCOUNT: 2421 AERIAL CABLE MET
CATEGORY: 2421 AERIAL CABLE MET
TABLE 1-VG/ELG

GENERATION ARRANGEMENT
DEVELOPMENT OF AVERAGE REMAINING LIFE AND AVERAGE SERVICE LIFE

EXPERIENCE AS OF 1-1-2000%					REMAIN	VINT		
VINT		AMOUNT	PROP	REAL	ING	AVG	AVERAGE	REMAINING
AGE	AGE	SURVIVING	SURV	LIFE	LIFE	LIFE	LIFE	LIFE
					YEARS	YEARS	WEIGHTS	WEIGHTS
N	A	B	C	D	E++	F+++	G=B/F	H=E*G
COMPUTED GROSS ADDS-ALL VINTS:					AVG PROPORTION SURVIVING:			
SUM OF (B/C)		378,790,281	B/ SUM OF (B/C)		0.43434			

USING IOWA CURVE: R1.0

* ELG VINTAGES, PROJECTION LIFE 12.0

++ FROM TABLE 2-VG/ELG; COL H FOR ELG, COL I FOR VG

+++ FROM TABLE 2-VG/ELG FOR ELG VINTAGES, COMPUTED AS $D + (C * E)$ FOR VG VINTAGES
% ACTUAL

ARIZONA PERCENT OF WORKING COPPER CHANNELS
1990-1999

Schedule WDA-27
Page 1 of 1

Year	Working Metallic Channels A (1)	Available Metallic Channels B (2)	% Metallic Channels Working C = A/B
1990	1,905,338	3,227,508	59.03%
1991	1,931,335	3,238,672	59.63%
1992	1,950,442	3,179,594	61.34%
1993	2,073,326	3,223,527	64.32%
1994	2,188,344	3,320,752	65.90%
1995	2,213,342	3,403,871	65.02%
1996	2,250,041	3,340,719	67.35%
1997	2,395,885	3,399,968	70.47%
1998	2,456,043	3,690,422	66.55%
1999	2,620,477	3,882,491	67.49%

Sources:

- (1) ARMIS 43-07, Table 2, Row 380
- (2) ARMIS 43-07, Table 2, Row 430

Arizona
Docket No. T-1051B-99-105
WDA 34-009

INTERVENOR: Arizona Corporation Commission Staff (Dunkel)

REQUEST NO: 009

Starting on page 11, line 12 of Mr. Wu's Rebuttal, referring to Mr. Dunkel's testimony, it is stated "He did not consistently use the appropriate 12/31/99 remaining lives."

A. Please list separately the name of each depreciable account in which you claim the remaining life used by Mr. Dunkel (Column G of Schedule WDA-6, page 1) was not the appropriate remaining life as of 12/31/99, using the Commission approved projection life and other Commission approved parameters.

B. For each account named in response to part A., please state what you contend the remaining life as of 12/31/99 to be.

C. For each of the remaining lives provided in response to part B., please provide the workpapers which show the calculation of that remaining life as of 12/31/99.

RESPONSE:

A. Please see Attachment A.

B. Please see Attachment A.

C. Please see Attachment B and C. Attachment B is the generation arrangement and projection life table reports that calculate remaining life. Attachment C is depreciation rate factor composite report that composites remaining life results for depreciation rate accounts with multiple study categories (2112 Motor Vehicles, 2121 Buildings, 2123.2 Company Comm Equip).

Jim Jones
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1801 California St.
Denver, CO 80202

08/24/00
04:05 PM
XREF: 03
PRES: 1991, SF, 02
PROP: 2000, SA, 96

COMPANY: U S WEST
STATE: ARIZONA
ACCOUNT: 2211 ANALOG SW EQUIP
CATEGORY: 2211 ANALOG SW EQUIP
TABLE 1-VG

GENERATION ARRANGEMENT
DEVELOPMENT OF AVERAGE REMAINING LIFE AND AVERAGE SERVICE LIFE

EXPERIENCE AS OF 1-1-2000%					REMAIN	VINT		
VINT		AMOUNT	PROP	REAL	ING	AVG	AVERAGE	REMAINING
AGE	AGE	SURVIVING	SURV	LIFE	LIFE	LIFE	LIFE	LIFE
					YEARS	YEARS	WEIGHTS	WEIGHTS
N	A	B	C	D	E++	F=D+(C*E)	G=B/F	H=E*G
1999	0.5	4,145,902	1.0000	0.50	0.99	1.49	2,777,929	2,756,937
1998	1.5	5,596,508	0.9645	1.48	0.99	2.44	2,294,322	2,276,719
1997	2.5	1,803,897	0.3799	1.87	0.99	2.25	802,776	796,521
1996	3.5	4,273,004	0.6813	3.30	0.99	3.98	1,073,426	1,064,929
1995	4.5	3,106,302	0.6363	3.91	0.99	4.54	683,486	677,989
1994	5.5	3,699,142	0.4150	4.55	0.99	4.96	746,275	740,174
1993	6.5	5,406,583	0.6705	5.62	0.99	6.29	859,720	852,575
1992	7.5	4,777,889	0.4708	6.12	0.99	6.59	725,393	719,263
1991	8.5	8,151,767	0.3835	6.77	0.99	7.15	1,140,448	1,130,645
1990	9.5	3,712,433	0.2299	6.77	0.99	6.99	530,772	526,130
1989	10.5	6,300,094	0.4017	8.24	0.99	8.64	729,115	722,624
1988	11.5	6,805,031	0.3677	8.00	0.99	8.37	813,457	806,085
1987	12.5	4,948,775	0.2490	9.16	0.99	9.41	525,962	521,107
1986	13.5	7,140,581	0.3135	10.15	0.99	10.46	682,424	676,006
1985	14.5	4,553,326	0.2525	9.73	0.99	9.98	456,084	451,713
1984	15.5	11,215,307	0.4750	11.53	0.99	12.00	934,741	925,607
1983	16.5	7,686,580	0.4115	13.06	0.99	13.47	570,556	564,869
1982	17.5	22,593,223	0.3607	14.56	0.99	14.92	1,514,491	1,499,089
1981	18.5	5,899,834	0.1270	13.62	0.99	13.74	429,367	424,910
1980	19.5	6,316,234	0.3013	14.63	0.99	14.93	423,124	418,639
1979	20.5	1,871,890	0.0731	13.28	0.99	13.36	140,159	138,641
1978	21.5	610,818	0.0437	14.69	0.99	14.74	41,449	40,990
1977	22.5	104,583	0.0100	15.31	0.99	15.32	6,825	6,748
1976	23.5	177,638	0.0239	14.41	0.99	14.44	12,306	12,164
1975	24.5	1,926,418	0.2065	15.82	0.99	16.02	120,214	118,789
1974	25.5	121,219	0.0255	14.91	0.99	14.94	8,116	8,018
1973	26.5	2,943,958	0.1986	17.23	0.99	17.42	168,987	166,883
1972	27.5	1,720,491	0.2697	19.51	0.99	19.78	86,999	85,888
1971	28.5	947,818	0.1349	16.81	0.99	16.94	55,948	55,215
1970	29.5	181	0.1240	16.78	0.99	16.91	11	11
1969	30.5	1,350	0.1132	16.76	0.99	16.87	80	79
1968	31.5	616	0.0212	16.30	0.99	16.32	38	37
1967	32.5	0	0.0000	0.00				
1966	33.5	415	0.0044	15.51	0.98	15.51	27	26
1965	34.5	668	0.0071	22.21	0.98	22.21	30	30
1964	35.5	362	0.1518	25.77	0.98	25.92	14	14
1963	36.5	0	0.0000	0.00				
1962	37.5	4,830	0.0030	21.96	0.98	21.96	220	216
1961	38.5	0	0.0000	0.00				
1960	39.5	0	0.0000	0.00				
1959	40.5	2,486	0.0186	21.40	0.98	21.42	116	114
1958	41.5	0	0.0000	0.00				
1957	42.5	0	0.0000	0.00				

08/24/00
 04:05 PM
 XREF: 03
 PRES: 1991,SF,02
 PROP: 2000,SA,96

COMPANY: U S WEST
 STATE: ARIZONA
 ACCOUNT: 2211 ANALOG SW EQUIP
 CATEGORY: 2211 ANALOG SW EQUIP
 TABLE 1-VG

GENERATION ARRANGEMENT
 DEVELOPMENT OF AVERAGE REMAINING LIFE AND AVERAGE SERVICE LIFE

EXPERIENCE AS OF 1-1-2000%					REMAIN	VINT		
VINT		AMOUNT	PROP	REAL	ING	AVG	AVERAGE	REMAINING
AGE	AGE	SURVIVING	SURV	LIFE	LIFE	LIFE	LIFE	LIFE
					YEARS	YEARS	WEIGHTS	WEIGHTS
N	A	B	C	D	E++	F=D+(C*E)	G=B/F	H=E*G
1956	43.5		0 0.0000	0.00				
1955	44.5	30,903	0.0556	35.56	0.98	35.62	868	848
TOTAL		138,599,059					19,356,273	19,187,239

AVG SERVICE LIFE: ALL VINTS

TOT B/TOT G 7.16042

AVG REMAINING LIFE: ALL VINTS

TOT H/TOT G 0.99127

COMPUTED GROSS ADDS-ALL VINTS: AVG PROPORTION SURVIVING:

SUM OF (B/C) 459,906,144 B/ SUM OF (B/C) 0.30136

INTERIM RETIREMENT RATE: 1.5

++ FROM INTERIM CURVE, TABLE 2-VG, AYFR 2000.5 % ACTUAL

08/24/00
 04:05 PM
 XREF: 03
 PRES: 1991,SF,02
 PROP: 2000,SA,96

COMPANY: U S WEST
 STATE: ARIZONA
 ACCOUNT: 2211 ANALOG SW EQUIP
 CATEGORY: 2211 ANALOG SW EQUIP
 TABLE 2-VG

PROJECTION LIFE TABLE
 DEVELOPMENT OF VINTAGE GROUP REMAINING LIFE BY AGE

INTERIM LIFE TABLE PARAMETERS

AVG YEAR OF FINAL RETIREMENT (AYFR) 2000.5
 UPDATE EXPERIENCE YEAR 2000

INTERIM RETIREMENT RATE: 1.5

AGE YEARS	PROPORTION SURVIVING	REMAINING LIFE OF SURVIVORS	AGE YEARS	PROPORTION SURVIVING	REMAINING LIFE OF SURVIVORS
A	B	C*	A	B	C*
0.5	0.99250	0.99	33.5	0.49750	0.98
1.5	0.97750	0.99	34.5	0.48250	0.98
2.5	0.96250	0.99	35.5	0.46750	0.98
3.5	0.94750	0.99	36.5	0.45250	0.98
4.5	0.93250	0.99	37.5	0.43750	0.98
5.5	0.91750	0.99	38.5	0.42250	0.98
6.5	0.90250	0.99	39.5	0.40750	0.98
7.5	0.88750	0.99	40.5	0.39250	0.98
8.5	0.87250	0.99	41.5	0.37750	0.98
9.5	0.85750	0.99	42.5	0.36250	0.98
10.5	0.84250	0.99	43.5	0.34750	0.98
11.5	0.82750	0.99	44.5	0.33250	0.98
12.5	0.81250	0.99	45.5	0.00000	0.50
13.5	0.79750	0.99	46.5	0.00000	0.50
14.5	0.78250	0.99	47.5	0.00000	0.50
15.5	0.76750	0.99	48.5	0.00000	0.50
16.5	0.75250	0.99	49.5	0.00000	0.50
17.5	0.73750	0.99	50.5	0.00000	0.50
18.5	0.72250	0.99	51.5	0.00000	0.50
19.5	0.70750	0.99	52.5	0.00000	0.50
20.5	0.69250	0.99	53.5	0.00000	0.50
21.5	0.67750	0.99	54.5	0.00000	0.50
22.5	0.66250	0.99	55.5	0.00000	0.50
23.5	0.64750	0.99	56.5	0.00000	0.50
24.5	0.63250	0.99	57.5	0.00000	0.50
25.5	0.61750	0.99	58.5	0.00000	0.50
26.5	0.60250	0.99	59.5	0.00000	0.50
27.5	0.58750	0.99	60.5	0.00000	0.50
28.5	0.57250	0.99	61.5	0.00000	0.50
29.5	0.55750	0.99	62.5	0.00000	0.50
30.5	0.54250	0.99	63.5	0.00000	0.50
31.5	0.52750	0.99	64.5	0.00000	0.50
32.5	0.51250	0.99	65.5	0.00000	0.50

* $C = 0.5 + ((\text{SUM OF COL B FROM AGE A+1 THROUGH AGE A+W}) / (\text{COL B AT AGE A}))$
 WHERE $W = \text{AYFR-UPDATE EXPERIENCE YEAR} = 2000.5-2000 = 0.5$

**CHANGE IN ANNUAL INTRASTATE DEPRECIATION ACCRUALS RESULTING FROM CHANGES IN DEPRECIATION RATES
ACC ORDERED PROJECTION LIVES AND NET SALVAGE APPLIED TO TEST YEAR INVESTMENT AND RESERVES**
(\$000)

PREVIOUS DEPRECIATION RATES													DEPRECIATION RATES USING ACC ORDERED PROJECTION LIVES, CURVES, AND NET SALVAGE APPLIED TO TEST YEAR INVESTMENTS AND RESERVES												
Account #	Class or Subclass of Plant	Intrastate Investment 12/31/1999 A (1)	Remaining Life Years B (2)	Reserve % C (2)	Future Net Salvage % D (2)	Previous Depreciation Rate E = (1 - C - D) / B	Rate Amount F = A x E	Proj. Lives G (4)	Reserve % I (5)	Future Net Salvage % J (3)	Depreciation Rate K = (1 - I - J) / G	Rate Amount L = A x K													
2112	MOTOR VEHICLES	\$47,502	3.9	41.0%	18.0%	10.5%	\$4,988	3.9	73.5%	16.0%	2.7%	\$1,283													
2114	SPEC PURPOSE VEHICLES	\$18	8.4	24.0%	23.0%	5.9%	\$1	7.3	2.5%	0.0%	13.4%	\$2													
2115	GARAGE WORK EQUIP	\$961	9.0	16.9%	23.0%	6.7%	\$64	9.7	-71.1%	-4.0%	18.1%	\$174													
2116	OTHER WORK EQUIP	\$15,891	8.4	27.7%	23.0%	5.9%	\$938	5.7	14.3%	7.0%	13.8%	\$2,193													
2121	BUILDINGS	\$115,383	28.0	15.4%	-10.0%	3.4%	\$3,923	25.0	34.3%	-6.0%	2.9%	\$3,346													
2122	FURNITURE	\$1,208	10.1	20.4%	3.0%	7.6%	\$92	4.8	-1.7%	0.0%	21.2%	\$256													
2123.1	OFFICE EQUIP	\$3,883	7.1	28.8%	5.0%	9.3%	\$361	3.0	42.5%	0.0%	19.2%	\$746													
2123.2	COMPANY COMM EQUIP	\$1,040	3.3	62.1%	1.0%	11.2%	\$116	3.9	153.3%	0.0%	0.0%	\$0													
2124	GEN PURPOSE COMPUTER	\$79,409	3.0	42.9%	5.0%	17.4%	\$13,817	2.1	85.5%	5.0%	4.5%	\$3,573													
2211	ANALOG SW EQUIP	\$110,824	8.4	34.7%	2.0%	7.5%	\$8,312	5.1	42.5%	3.0%	10.7%	\$70,091													
2212	DIGITAL SW EQUIP	\$655,053	10.4	16.3%	3.0%	7.8%	\$51,094	5.2	64.4%	-3.0%	7.4%	\$481													
2220	OPERATOR SYSTEMS	\$6,498	1.4	4.1%	3.0%	66.4%	\$4,315	5.9	82.5%	-2.0%	3.3%	\$778													
2231	RADIO SYSTEMS	\$23,571	8.1	34.5%	-8.0%	9.1%	\$2,145	3.8	106.0%	3.0%	0.0%	\$0													
2232	CIRCUIT DDS	\$5,667	4.0	50.5%	-4.0%	13.4%	\$759	5.1	52.6%	2.0%	8.9%	\$66,995													
2232	CIRCUIT DIGITAL	\$752,751	7.9	27.8%	3.0%	8.8%	\$66,242	3.1	95.3%	0.0%	1.5%	\$489													
2232	CIRCUIT ANALOG	\$32,631	5.0	39.1%	3.0%	11.6%	\$3,785	6.3	53.1%	2.0%	7.1%	\$2,847													
2362	OTHER TERM EQUIP	\$40,092	7.9	27.8%	3.0%	10.9%	\$4,370	3.5	0.0%	30.0%	N/A	\$0													
2351	PUB TEL TERM EQUIP	\$17,969	2.7	94.6%	1.0%	1.6%	\$288	25.0	79.1%	-138.0%	6.4%	\$2,202													
2411	POLE LINES	\$34,403	15.6	55.9%	-49.0%	6.0%	\$2,064	5.1	78.2%	-27.0%	9.6%	\$11,656													
2421	AERIAL CABLE MET	\$121,417	9.3	27.3%	-23.0%	10.3%	\$12,506	10.6	28.6%	-27.0%	9.3%	\$424													
2421	AERIAL CABLE NON MET	\$4,563	15.5	4.0%	-27.0%	7.9%	\$360	5.6	62.5%	-6.0%	7.8%	\$20,050													
2422	UNGRD CABLE MET	\$257,054	13.8	24.9%	-9.0%	6.1%	\$15,680	6.0	38.6%	-6.0%	11.2%	\$7,190													
2422	UNGRD CABLE NON MET	\$64,194	18.7	7.8%	-21.0%	6.1%	\$3,916	5.2	44.7%	-7.0%	11.1%	\$102,924													
2423	BURIED CABLE MET	\$927,241	14.8	25.7%	-2.0%	5.2%	\$48,217	10.6	38.2%	-7.0%	6.7%	\$853													
2423	BURIED CABLE NON MET	\$12,727	20.0	10.0%	-9.0%	5.0%	\$636	0.5	4.0%	0.0%	192.0%	\$4													
2424	SUB CABLE MET	\$2	22.0	-80.9%	0.0%	8.2%	\$0	20.0	0.0%	0.0%	5.0%	\$0													
2424	SUB CABLE NON MET	\$0	13.9	36.8%	0.0%	14.0%	\$0	7.7	75.7%	0.0%	3.2%	\$969													
2426	INTRA BLDG CABLE MET	\$30,275	14.1	53.1%	-12.0%	4.2%	\$1,272	6.2	41.2%	0.0%	9.5%	\$41													
2426	INTRA BLDG CABLE NON MET	\$429	12.5	-14.0%	-33.0%	11.8%	\$51	5.6	32.6%	-30.0%	17.4%	\$1,130													
2431	AERIAL WIRE	\$6,494	12.0	12.2%	-32.0%	10.0%	\$649	41.0	24.3%	-20.0%	2.3%	\$5,178													
2441	CONDUIT SYSTEMS	\$225,140	47.0	16.2%	-11.0%	2.0%	\$4,503																		
	TOTAL	\$3,594,290					\$255,464					\$305,873													
	COMPOSITES						7.1%					8.5%													

Footnotes:

- (1) Wu Direct Testimony Exhibit KDW-2.
- (2) Wu Direct Testimony Exhibit KDW-1, page 1.
- (3) ACC Ordered Net Salvage, as shown on Wu Direct testimony Exhibit KDW-1, page 1.
- (4) USWC's Response to Data Request WDA 21-151, Attachment A-2.
- (5) Wu Rebuttal Exhibit KDW-2.
- (6) See Mr. Dunkel's Surrebuttal Testimony for discussion of Staff's proposed amortization for account 2211 - Analog Switching Equipment.

**THIS SCHEDULE CONTAINS INFORMATION
DESIGNATED AS PROPRIETARY OR
CONFIDENTIAL BY QWEST AND HAS BEEN
EXCLUDED FROM THIS REDACTED TESTIMONY**

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QWEST (US WEST COMMUNICATIONS)

ARIZONA CORPORATION COMMISSION

DOCKET NO. T-01051B-99-105

SURREBUTTAL TESTIMONY

OF

STEPHEN G. HILL

ON BEHALF OF

THE

ARIZONA CORPORATION COMMISSION STAFF

September 8, 2000

EXECUTIVE SUMMARY

Mr. Hill responds to the Rebuttal Testimony of Company rate of return witness Peter Cummings. Mr. Cummings' rebuttal is, in the main, short on substance and does not cause Mr. Hill to change his testimony or recommendation to the Commission in any way. Mr. Hill continues to recommend that an equity return of 11.75% and an overall return of 9.55% be utilized to set rates for the Company's local exchange operations in Arizona.

Company witness Cummings claims that Mr. Hill's use of gas distribution companies to establish the lower end of a range of reasonable equity returns for the Company is improper. However, Mr. Cummings' focus is on Qwests' corporate operations, not on the portion of that company for which rates are to be set in this proceeding—Qwests' local exchange operations in Arizona. Mr. Hill demonstrates that he has provided very specific evidence regarding the operations of Qwests' Arizona local exchange operations which indicates that the Company has similar operating risk to gas distributors. Those data were confirmed independently by other witnesses in this proceeding. Mr. Cummings' rebuttal fails to discuss any of those Company-specific, Arizona-specific operating risk issues presented by Mr. Hill.

Mr. Cummings also takes issue with Mr. Hill's use of telecommunications holding companies to establish the upper end of a reasonable range of equity returns for the Company. However, the fact that large, diversified telecommunications holding companies (which hold substantial stakes in wireless, cable and overseas telephone operations) are riskier than local exchange operations is widely accepted and confirmed by the telcos themselves in their S.E.C. filings. As support for that position, Mr. Hill cites the recent Order by the Vermont Public Service Board in an equity return determination for Bell Atlantic (now Verizon). That Order found that an 11.5% equity return was reasonable, and confirmed that it is widely understood in the financial community that local exchange operations are less risky than the operations of the larger, diversified telecommunications holding companies.

Mr. Cummings also questions Mr. Hill's use of property/casualty insurance companies as support for the upper end of a reasonable range of equity returns for Qwest's local exchange operations in Arizona. However, Mr. Hill discusses the need for additional support for the upper end of his range due to the relatively small (and dwindling) number of large telecom firms that have significant local telephone operations. Mr. Hill also points out that those firms are both fully-competitive and rate regulated and, therefore, are similar regulatory risk-wise to the telecom companies. Finally, the average beta coefficient of those insurance firms studied by Mr. Hill is *greater* than the average beta coefficient of the telecommunications holding companies, signifying greater risk for the former. That factor indicates the use of insurance companies is a conservative proxy for the equity return of large telecom holding companies. Mr. Cummings, who relies heavily on beta in his cost of capital analysis is silent in his rebuttal on that issue and, instead, opines that Mr. Hill's use of insurance companies as an additional indicator of the upper end of a reasonable range of equity returns for the Company "just doesn't make sense." Mr. Cummings position does not constitute reliable rebuttal to Mr. Hill's use of competitive firms to set the upper end of a reasonable equity cost range in this proceeding.

In his Rebuttal Testimony, Company witness Cummings opines that Mr. Hill's "failure" to rely solely on earnings growth rate projections is at odds with normal cost of capital estimation practice. That concern is unfounded. Mr. Hill's equity cost analysis is based on sound financial economics, is well within the norms exhibited by rate of return professionals and has been accepted for ratemaking purposes. Mr. Hill devotes a significant portion of his Direct Testimony to explaining the accounting mechanics of how growth actually occurs in regulated firms, citing references to the financial literature, and discussing in detail the growth rate analysis of each company he analyzes. In addition, Mr. Hill discusses the problems of basing DCF growth rate exclusively on earnings growth projections. In exploring that latter point, Mr. Hill again relies on his research and understanding of the financial literature and shows that, while earnings growth rate estimates are influential and should certainly be considered in determining the long-term sustainable growth rate called for in the DCF, they should not be given

exclusive consideration. Investors have access to many different types of growth rate information (e.g., historical and projected growth in dividends, sustainable growth, and book value as well as earnings) and it is simply not reasonable to believe—as witness Cummings implies—that investors, en masse, ignore all growth rate indicators except projected earnings growth.

The final issue to which Mr. Cummings devotes a rather large portion of his Rebuttal Testimony addresses one portion of the Capital Asset Pricing Model (CAPM)—the market risk premium. Specifically, there are two ways to calculate an average market risk premium from historical data. The first is a geometric mean, which is effectively the compound growth over the entire period. The second is an arithmetic mean, which is the sum of the yearly growth rates divided by the number of years. Mr. Hill uses both averages in his CAPM, and Mr. Cummings believes only the arithmetic average is proper. Mr. Cummings recognizes in his rebuttal that the issue of which growth rate average is correct is undecided in the financial literature. Nevertheless, he concludes that only the arithmetic mean should be considered in the CAPM. Mr. Hill's surrebuttal shows that the key rationale on which Mr. Cummings' support of the arithmetic mean rests is, itself, controversial in the literature, and the issue of which historical average to use is not as black and white as Mr. Cummings' rebuttal indicates. In addition, Mr. Hill notes that investors have equal access to both averages which are published in the same source and other studies of historical return data indicate that both averages may be conservative (i.e., too high) for cost of capital estimation purposes. In sum, Mr. Cummings extensive rebuttal on this rather small point is unconvincing and Mr. Hill's position that all of the available data (both the geometric and arithmetic averages) should be used in an accurate CAPM analysis remains reasonable.

INTRODUCTION / SUMMARY

Q. PLEASE STATE YOUR NAME, OCCUPATION AND ADDRESS.

A. My name is Stephen G. Hill. I am self-employed as a financial consultant, and principal of Hill Associates, a consulting firm specializing in financial and economic issues in regulated industries. My business address is P. O. Box 587, 4000 Benedict Road, Hurricane, West Virginia, 25526 (e-mail: sghill@compuserve.com).

Q. ARE YOU THE SAME STEPHEN HILL WHO TESTIFIED PREVIOUSLY IN THIS PROCEEDING ON BEHALF OF THE STAFF OF THE ARIZONA CORPORATION COMMISSION REGARDING COST OF CAPITAL ISSUES?

A. Yes, I am. In my Direct Testimony in this proceeding I presented a cost of capital analysis for the Arizona local exchange operations of Qwest, formerly US WEST Communications, Inc. (Qwest, the Company). That analysis indicated that the cost of equity capital for Qwest's Arizona local exchange operations is 11.75% (the mid-point of a reasonable range, 11% to 12.5%) and the overall cost of capital which should be utilized for ratesetting purposes is 9.55%.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY AT THIS TIME?

A. I will respond to the Rebuttal Testimony of Company witness Peter Cummings.

Q. HAS THE REBUTTAL TESTIMONY OF COMPANY WITNESS CUMMINGS CAUSED YOU TO AMEND YOUR TESTIMONY OR YOUR RECOMMENDATIONS TO THE COMMISSION IN ANY WAY?

A. No. Except for his testimony addressing one portion of one type of corroborative cost of capital model, Mr. Cummings rebuttal is, in the main, extremely short on substance. It fails to address objective differences between our analytical techniques that might be tied to

1 underlying economic theory and relies, instead, on disparaging remarks about me,
2 personally. As such, it amounts to very little rebuttal of substance. Moreover, as I will
3 demonstrate subsequently, the information presented by Mr. Cummings in the one area in
4 which he does present substantial rebuttal—the selection of a Capital Asset Pricing Model
5 (CAPM) market risk premium—supports my position on that issue.

6
7 Q. HOW WILL YOUR SURREBUTTAL TESTIMONY BE ORGANIZED?

8 A. I will respond to the issues raised by Company witness Cummings in the order presented
9 in his Rebuttal Testimony. Mr. Cummings discusses the relative risk of local exchange
10 telephone operations, the growth rate parameters in the Discounted Cash Flow (DCF)
11 analysis and the selection of the market risk premium in the Capital Asset Pricing Model
12 (CAPM).

13
14 Q. IS YOUR EQUITY COST ESTIMATE RANGE FOR QWEST'S ARIZONA LOCAL
15 EXCHANGE OPERATIONS OF 11% TO 12.5%, WITH A MID-POINT OF 11.75%,
16 REASONABLE FOR RATESETTING PURPOSES IN THIS PROCEEDING?

17 A. Yes. As I demonstrated in significant detail in my Direct Testimony an equity cost estimate
18 range for the Company's local exchange telephone operations in Arizona of 11% to 12.5%
19 properly recognizes the return equity investors require for the risk of those operations,
20 provides a return which will allow the Company to attract capital and, thus, balances the
21 interests of investors and ratepayers. Mr. Cummings' testimony to the contrary is incorrect.

22
23 Q. AT PAGE 16 OF HIS REBUTTAL MR. CUMMINGS CLAIMS THAT GAS
24 DISTRIBUTION COMPANIES SHOULD NOT BE USED TO DETERMINE THE
25 LOWER END OF A REASONABLE RANGE OF PROFITABILITY FOR THE
26 COMPANY. IS THAT CORRECT?

27 A. No. It is correct, as I point out in my Direct Testimony, that gas distribution operations are
28 less risky than local exchange telephone operations. However, Mr. Cummings' rebuttal
29 conclusion, i.e., that the market-determined cost of equity capital of gas distribution

1 companies is not useful in assisting the determination of a cost of equity range for local
2 exchange companies, is incorrect. Moreover, there are many flaws in the subjective
3 rationale he offers.

4 First, when Mr. Cummings discusses the "Company's" operating risk, he is careful
5 to refer to the entire company—the telecommunications holding company (Qwest
6 Corporation). However, the focus in this proceeding and the ostensible object of our
7 inquiry is the Arizona local exchange telephone operations, not any of Qwest's other
8 (arguably more risky) operations. Therefore, when Mr. Cummings testifies that Qwest
9 Corporation is considerably more risky than gas distributors, he's correct, but he's off
10 point. Qwest Corporation is also considerably more risky than its local exchange operations
11 in Arizona. What Mr. Cummings purposefully overlooks in his focus on Qwest
12 Corporation is that the Company's local exchange operations, while carrying somewhat
13 more risk than gas distribution operations, have a risk profile that is similar in many ways
14 to gas distributors. I discuss the ways in which local exchange operations are similar to gas
15 distribution operations in my direct testimony at pages 19 and 20. Mr. Cummings does not
16 discuss that testimony in his rebuttal.

17 Second, Mr. Cummings cites the average beta for the telecommunications holding
18 companies (0.84) as evidence that "the Company" has substantially greater risk than gas
19 distribution companies (beta = 0.55). Again, Mr. Cummings grounds his position on the
20 wrong company, i.e., comparing the risk of the much riskier, more diverse
21 telecommunications holding companies to the risk of gas distributors. However, we are not
22 setting rates for a diversified telecommunications holding company, we are setting rates for
23 a local exchange telephone company which remains, in many ways, similar to a gas utility
24 operation. Also, as I point out in Appendix D attached to my Direct Testimony in this
25 proceeding, beta, alone, is not a particularly reliable measure of relative risk. Finally, it is
26 curious that Mr. Cummings would rely so heavily on beta to support his rejection of my
27 gas distribution proxy group. That is because the average beta coefficient of my insurance
28 proxy group (according to Mr. Cummings' own Rebuttal Schedule PCC-01, page 2) is
29 higher than the average beta of even the telecommunications holding companies (0.94 v.

1 0.82). In that instance his preferred risk measure, beta, indicates that the insurance proxy is
2 riskier than the telecom holding companies; and should yield conservative (high) equity
3 cost result. Yet, Mr. Cummings rejects my use of those insurance companies as well.
4 Thus, it appears that his reliance on beta as a risk similarity measure is selective in that it
5 eliminates only the lower risk, lower return companies.

6 Third, following my discussion of the similarities between local exchange telephone
7 and gas distribution operations, at page 21 of my Direct Testimony, I discuss very specific
8 issues related to the market share of the Company's Arizona local exchange operations.
9 Those data show that the Company, even following the onset of competition, continues to
10 control an enormous share of the market. Moreover, the Company's local exchange
11 revenues have shown strong, steady growth over the past ten years and, over the past four
12 years (a period when competition is supposedly creating greater operating risk) the
13 Company's Arizona jurisdictional revenues grew even more rapidly. That jurisdictional
14 operating history is based on the Company's own confidential information and was
15 confirmed independently in the Direct Testimony of AT&T witness Selwin in this
16 proceeding:

17 "A primary public source of this information is the
18 competition data submitted by the ILECs to the FCC's
19 Common Carrier Bureau on a voluntary basis. The most
20 recent such data was reported as of June 30, 1999. The
21 information reported to the FCC by US West for Arizona
22 shows that 0.5 percent—that is, one-half of one percent—of
23 the Company's switched lines were being provided to
24 CLECs for "total service resale" [footnote omitted] UNE
25 loops leased by CLECs from US West in Arizona accounted
26 for another 0.1 percent of US West's switched access lines
27 [footnote omitted], for a grand total of six-tenths of one
28 percent [footnote omitted]." (Selwin Direct, p. 8, l. 17
29 through p. 9, l. 2)
30

31 These data, along with similar information provided in my direct testimony show
32 quantitatively that the Company's local exchange operations retain operating characteristics
33 that are similar to utilities. Importantly, Mr. Cummings offers not one word in rebuttal
34 regarding the Company's market share in Arizona or the Company's jurisdictional financial
35 operating results.

1 In sum, as I noted above, I recognize that due to the nature of telecommunications
2 services and the technological innovation which exists in that industry, local exchange
3 telephone companies have somewhat more risk than regulated utility operations. However,
4 in many ways, not the least of which is market share, the operating risk of local exchange
5 telephone operations are similar to those faced by gas distributors. Therefore, it is
6 reasonable to use, as I have in my testimony, the uppermost end of a reasonable range of
7 equity returns for gas distributors as the lowest end of a reasonable range of equity returns
8 for local exchange telephone operations. That means that the very lowest equity return I
9 would recommend for the least risky local exchange company would be equal to that
10 appropriate for the riskiest gas distribution operation. Of course, the equity return I
11 recommend for Qwest's Arizona operations is well above (75 basis points) that level. Mr.
12 Cummings' rebuttal regarding my use of gas distribution companies to establish a lower
13 bound of equity returns for local exchange companies is off-point, logically inconsistent,
14 and selectively ignores quantitative evidence provided by the Company and confirmed by
15 other witnesses in this proceeding that the Company's operating risk is, indeed, somewhat
16 similar to that of a utility operation.

17
18 Q. SUBSEQUENT TO HIS TESTIMONY REGARDING GAS COMPANIES, MR.
19 CUMMINGS INDICATES THAT THE UPPER BOUND OF A RETURN RANGE
20 SHOULD BE EQUIVALENT TO, NOT AT THE LOWER END OF A REASONABLE
21 RANGE FOR TELECOMMUNICATIONS HOLDING COMPANIES. IS HE
22 CORRECT?

23 A. No. The fact that local exchange telephone company operations carry lower risk than the
24 diversified holding companies is widely recognized in the financial media, by the
25 companies themselves, and, as shown in the quote below, by regulators:

26 "The greater risks posed by the diversified holdings of
27 RBHCs [telecom holding companies], as opposed to the
28 relative safety of their local exchange operations, is well
29 documented, thus warranting the use of the low end of the
30 group [to set the upper end of a reasonable range for local
31 exchange operations]. Bell Atlantic Corporation in its SEC
32

1 Form S-4 related to its merger with NYNEX, represented to
2 the investment community that the holding company as a
3 whole is a more risky venture than its local exchange
4 telephone operations [footnote omitted]. Merrill Lynch, pre-
5 merger Bell Atlantic's financial advisor for that deal, set a
6 discount rate for the local telephone operations of Bell
7 Atlantic Corporation and NYNEX of 8 to 10 percent, and set
8 discount rates for the holding companies' other businesses,
9 such as long distance and cellular, at 10 to 14 percent. Bond
10 rating agencies have confirmed that the local exchange
11 operations of an RBHC present a far lower risk profile than
12 that of the RBHC with its diversified holding of risky
13 enterprises [footnote omitted]." (Vermont Public Service
14 Board Order in Docket Nos. 6167 and 6189, Investigation
15 into an Alternative Regulation Plan for New England
16 Telephone and Telegraph Company d/b/a Bell Atlantic-
17 Vermont, March 24, 2000, p. 75)

18
19 It should also be noted that in the recent Vermont Order cited above, that regulatory body
20 not only accepted the lower end of the cost of equity range for the telecommunications
21 holding companies as reasonable for the upper end of the cost of equity range for local
22 exchange operations, they accepted the reasonableness of using the upper end of the cost of
23 equity range for gas distributors as the lower end of the cost of equity range for local
24 exchange operations.
25

26 Q. AT PAGE 20 OF HIS REBUTTAL, MR. CUMMINGS QUESTIONS YOUR USE OF
27 INSURANCE COMPANIES AS SIMILAR-RISK PROXIES TO THE
28 TELECOMMUNICATIONS COMPANIES. HOW DO YOU RESPOND?

29 A. Mr. Cummings cites a portion of my testimony which underscores the fact that insurance
30 companies are fully-competitive firms and then opines that my selection of those firms as
31 similar-risk proxies to the telecom holding companies "doesn't make sense." Yet, it is Mr.
32 Cummings who insists the Company is "in competition with other providers" (Cummings
33 Rebuttal, p. 17, l. 5). It would seem, then, that fully-competitive firms like insurance
34 companies would make at least some "sense" to Mr. Cummings.

35 It is important to recall, as I noted in my Direct Testimony, that I elected to analyze
36 the equity cost of the insurance companies in addition to the telecommunications holding

1 companies because the latter were undergoing mergers and had shrunk to just five in
2 number. The fluctuating corporate alliances as well as the small number of firms in the
3 telecommunications sample group, in my view, made the equity cost estimate for those
4 companies somewhat less reliable than it has been in the past. For those reasons, I elected to
5 bolster the equity cost estimate for the telecommunications firms (the high end of a
6 reasonable range for local exchange companies) by analyzing property/casualty insurance
7 companies.

8 Also, a portion of my testimony, immediately following the section that Mr.
9 Cummings elects to cite, discusses the fact that insurance companies (unlike grocery stores,
10 for example) are rate-regulated operations. That fact also makes them reliable proxies for
11 the telecom companies which have a portion of their operations (local exchange companies)
12 that are rate-regulated. Mr. Cummings fails to discuss this point.

13 Finally, the average beta coefficient of the insurance companies is higher than that
14 of the telecommunications holding companies. As I noted, Mr. Cummings relies heavily on
15 the beta risk measure in both his Direct and Rebuttal testimonies, but is silent on that issue
16 here. According to that risk measure, the insurance companies are not only relatively
17 similar in risk to the telecom holding companies—they have greater risk. That would mean
18 that an equity cost determined for those companies would exceed that appropriate for even a
19 telecom holding company. It would seem that the beta risk measure would be sufficient to
20 indicate a high enough risk level to suit Mr. Cummings, but, again, he is silent on that
21 subject and simply declares that my use of insurance company proxies “makes no sense.”

22 In fact, the use of insurance companies as proxies for diversified telecom holding
23 companies makes plenty of sense from both a quantitative (statistical) and qualitative
24 (economic) standpoints, and the results of my equity cost analysis of those companies (as
25 shown on page 44 of my direct Testimony) is, indeed very similar to the telecom holding
26 companies. As such, it confirms the reasonableness of the upper end of my recommended
27 range for the Company’s local exchange operations. Mr. Cummings’ rebuttal on this point
28 should be ignored.
29

1 Q. MR. CUMMINGS CHARACTERIZES YOUR USE OF INSURANCE COMPANIES TO
2 SUPPORT THE EQUITY COST ESTIMATE OF THE TELECOM HOLDING
3 COMPANIES AS "AD HOC." HE MAKES THE SAME COMMENT REGARDING
4 YOUR DCF GROWTH RATE ANALYSIS. WHAT DOES HE MEAN BY THAT?

5 A. The Webster's¹ dictionary I have in my office defines "ad hoc" as something that is "for a
6 specific purpose, case, or situation," as in "an ad hoc committee was formed to study the
7 problem." We can safely assume that the "specific purpose" afforded my DCF growth rate
8 analysis or my use of insurance companies by Mr. Cummings is not "to estimate the cost of
9 equity of a local exchange operation." If that were the case, calling my analysis "ad hoc"
10 would not constitute rebuttal; it would be an affirmation. What Mr. Cummings implies is
11 that I have simply made up an analysis which produces the results I want. This is a
12 completely false and self-serving assertion.

13 In response, I would note three things. First, as I discussed above, I provided
14 specific rationale for the use of additional proxy companies. Mr. Cummings elected to
15 ignore that rationale in his rebuttal and cast aspersions instead.

16 Second, my DCF growth rate analyses for each of the companies I analyzed in my
17 Direct Testimony is discussed in great detail in Appendix C attached to that testimony.
18 Moreover, in the body of my Direct and in Appendix B attached to it, I discuss the
19 theoretical rationale on which that growth rate analysis is grounded and provide cites to the
20 sources. Finally, I discussed the flaws in relying exclusively on earnings growth rate
21 projections, showing the wide variability of those estimates and discussing the studies in
22 the financial literature which purportedly support the use of earnings growth measures. Mr.
23 Cummings "rebuttal" fails to discuss the merits or demerits of any portion of my growth
24 rate analysis—not one sample group, not one company, not a portion of the analysis of any
25 company...nothing. He merely dubs it "ad hoc."

26 Third, Mr. Cummings and I have testified against each other many times over many
27 years. He knows very well that the methodologies I use are based on economic theories

¹ Webster's II, New Riverside University Dictionary, Riverside Publishing Company, Houghton Mifflin Company, Boston MA, 1988.

1 that are widely accepted and have been applied in a consistent manner. The analytical
2 methods I have used to estimate the cost of equity have been consistent for more than
3 fifteen years and have been accepted by regulatory agencies. The notion that I have
4 somehow "fixed" the 11.75% equity cost estimate I present in this proceeding prior to
5 undertaking my analysis is just plain silly, as are Mr. Cummings' comments that my
6 analysis was done on an "ad hoc" basis to produce a specific result.

7
8 Q. AT PAGE 24 OF HIS REBUTTAL, MR. CUMMINGS INDICATES THAT YOUR DCF
9 GROWTH RATE ANALYSIS IS FLAWED BECAUSE YOU HAVE NOT RELIED ON
10 ANALYST'S GROWTH RATE PROJECTIONS. IS THAT CORRECT?

11 A. No. The "consensus" analyst's growth rate estimates to which Mr. Cummings refers are
12 earnings growth rate estimates. I have considered those growth rates in my analysis, but
13 have not slavishly plugged them into a DCF analysis because to do so, absent consideration
14 of any other widely-available growth rate data, would run the risk of producing equity cost
15 estimates which are seriously in error.

16 There are many reasons for this, all of which I discuss in detail in my Direct
17 Testimony. The notion of a "consensus" growth expectation among analysts is not a
18 reality. As shown in Table I on page 52 of my Direct Testimony, analysts' earnings growth
19 rate estimates for the telecommunications holding companies showed an average range of
20 about 800 basis points from the lowest growth rate estimate to the highest.

21 Appendix B attached to my testimony shows how earnings growth rates can be
22 distorted by operating changes and that sole reliance on that one measure of growth can
23 produce unreliable equity cost estimates. There are many other growth rate measures, both
24 historical and projected, which are widely available to investors and should be considered
25 in order to determine the long-term sustainable growth rate called for in the DCF model
26 (e.g., dividend and book value growth rates).

27 Finally, as I also noted in my Direct Testimony, the academic studies that show
28 analysts' earnings growth projections to be superior price predictors are all based on
29 comparing those projections with simple historical average growth rates. If I were basing

1 my DCF cost of capital estimate solely on historical average growth rates, Mr. Cummings'
2 rebuttal might have some moment. However, my DCF growth rate analysis—spelled out in
3 detail for each company analyzed in Appendix C attached to my Direct Testimony—is
4 based not on simple historical growth rates of one particular measure but trends in historical
5 growth of many variables in combination with projected growth rates for earnings,
6 dividends and book value—all of which are publicly available analysts' projections.

7
8 Q. THE LAST ISSUE RAISED BY MR. CUMMINGS IN REGARD TO YOUR
9 TESTIMONY IS THE SELECTION OF A PARTICULAR KIND OF MATHEMATICAL
10 AVERAGING TECHNIQUE. HE DEVOTES SEVERAL PAGES OF TESTIMONY AND
11 A 19-PAGES APPENDIX TO THIS ISSUE; CAN YOU PUT THIS INTO
12 PERSPECTIVE?

13 A. Yes. The issue to which Mr. Cummings has devoted a great deal of his rebuttal is one
14 portion of the Capital Asset Pricing Model. In that econometric model, the cost of capital is
15 equal to the risk-free rate of return (U.S. Treasury bills) plus beta (a measure of relative
16 risk) times the market risk premium (the historical average difference between the return on
17 stocks and the return on Treasury bills). The formula is expressed as follows:

$$k = r_f + \beta(r_m - r_f), \quad (1)$$

18
19
20 where "k" is the cost of equity capital of an individual security, "r_f" is the risk-free rate of
21 return, "β" is the beta coefficient, "r_m" is the average market return and "r_m - r_f" is the
22 market risk premium. Mr. Cummings rebuttal testimony focuses only on that last term in
23 the CAPM equation—the market risk premium.

24
25 There are two ways to calculate the average historical return difference between
26 stocks and bonds: geometric averaging and arithmetic averaging. As I explained in my
27 Direct Testimony at page 35, geometric averaging is the nth root of the product of "n"
28 numbers and produces what amounts to a compound return over time. Arithmetic averaging
29 is the mean of the sum of the individual yearly returns and (based on the Ibbotson data used

1 by Mr. Cummings and myself) assumes monthly selling and re-buying of the entire market
2 portfolio.

3 In my CAPM analysis I have used both the geometric and the arithmetic mean
4 market risk premium published by Ibbotson associates (7.4% and 9.4%), while Mr.
5 Cummings uses only the arithmetic mean (9.4%). The difference between the average
6 market risk premium I used in my CAPM (8.4%) and that used by Mr. Cummings (9.4%)
7 is 100 basis points. Depending on the value of beta (e.g., 0.56 for gas distributors, 0.84
8 for telecom holding companies²) the difference in the choice of market risk premium can
9 have an impact on the CAPM result of 50 to 80 basis points. It is to this issue that Mr.
10 Cummings devotes more than 20 pages of his rebuttal testimony.

11
12 Q. IS MR. CUMMINGS CORRECT THAT ONLY THE ARITHMETIC MEAN SHOULD
13 BE CONSIDERED IN A CAPM COST OF EQUITY ESTIMATE?

14 A. No. As even Mr. Cummings admits at the outset of his long discussion of this issue,
15 "...there is not universal agreement among finance academics and practitioners." This,
16 some believe that the arithmetic mean is appropriate, some believe the geometric mean is
17 appropriate. Both means are published by the same data source (Ibbotson Associates) and
18 are equally available to investors. The decision to use both the geometric and arithmetic
19 mean market risk premium is supported by both theoretical and practical reasons.

20
21 Q. WHAT, THEN, IS THE NEXUS OF MR. CUMMINGS' CONCERN REGARDING
22 THIS ISSUE?

23 A. Because Mr. Cummings admits that both the geometric and arithmetic means are supported
24 in the literature and because this issue is relegated to one portion of a methodology which I
25 believe should be used only in a corroborative role in ratemaking, and because I have
26 already discussed this issue in some detail, my discussion here will be brief.

27 As is invariably the case with economic theory, the assumptions used to construct
28 the theory are an extremely important part of the whole, and the rationale on which Mr.

² Cummings Rebuttal. Exhibit PCC-01, pp. 1, 2.

1 Cummings bases his support for the use of arithmetic averaging is no exception. One key
2 assumption on which the arithmetic-is-best logic lies is illustrated by the decision tree
3 shown on page 2 of Mr. Cummings' rebuttal Appendix I. That decision tree logic
4 represents the investor's decision with a hypothetical scenario in which she has an equal
5 chance of earning a return of +30% or -10% in any one year. That scenario gives rise to
6 the "most common outcome" (the geometric mean) but, according to that logic, the
7 "expected return" is the arithmetic mean, which due to the uncertain probability distribution
8 of returns is a larger number than the geometric mean. This economic theory holds, then,
9 that the arithmetic mean is the proper return to use for cost of capital purposes because it
10 purportedly represents investors' expectations.

11 It is important to remember that I do use the arithmetic mean in my CAPM analysis,
12 so I do not completely discount the logic extant in the decision tree theory. However, that
13 logic has problems that Mr. Cummings does not discuss. Key among those problems is
14 that the decision tree theory assumes that each possible outcome in any period (the +30% or
15 -10% returns in Mr. Cummings' Appendix I, p. 2, decision tree) is statistically
16 independent from any other outcome. That is, the return in any one period is not dependent
17 in any way on what happened the previous period, or related in any way to any alternative
18 return that might occur. As noted in the Copeland text cited in my Direct Testimony, that
19 turns out to be an assumption that is disputed in the literature of financial economics. In
20 constructing their own version of the decision tree logic discussed above those authors
21 note:

22 "To contrast the geometric and average [arithmetic] rates of
23 return, we can go back to the earlier example where we
24 observed two periods of return, the first with a rate of return
25 of 100 percent and the second with -50 percent. What can
26 we infer from these data? *If we are willing to make the*
27 *strong assumption that each return is an independent*
28 *observation from a stationary underlying probability*
29 *distribution*, then we can infer that four equally likely return
30 paths actually exist: 100 percent followed by 100 percent,
31 100 percent followed by -50 percent, -50 percent followed
32 by 100 percent and -50 percent followed by -50 percent.
33 These possibilities are illustrated in Exhibit 8.5 [a decision
34 tree, omitted]. The shaded area represents what we have
35

1 actually observed [the geometric mean], and the remainder of
2 the binomial tree is what we have inferred by assuming
3 independence....

4 Finally, empirical research by Fama and French
5 (1988), Lo and MacKinlay (1988), and Poterba and
6 Summers (1988) indicates that a long-term negative
7 correlation exists in stock returns [footnote omitted]. *Hence,*
8 *historical observations are not independent draws from a*
9 *stationary distribution.* (Copeland, T., Koller, T., Murrin,
10 J., Valuation, Measuring and Managing the Value of
11 Companies, 2nd Ed., Wiley & Sons, New York, 1994, pp.
12 262-3, emphasis added)
13

14 Therefore, while the decision tree logic appears compelling, a key assumption on which it
15 rests is at odds with evidence available in the financial literature³.

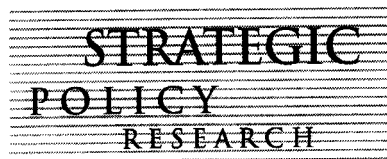
16 There are many other reasons offered in my Direct Testimony (pp. 34-36) regarding
17 practical shortcomings of an arithmetic average which I will not repeat here. In addition, it
18 should be noted that, in my Direct Testimony, I discussed other available estimates of long-
19 term market risk premium data which indicate that the Ibbotson data (including the lower
20 geometric mean) may substantially overstate the actual market risk premium investors
21 utilize. Mr. Cummings makes no comment regarding that testimony.

22 In sum, as I noted in my Direct Testimony, while the arithmetic average market risk
23 premium should be considered in developing a CAPM cost of equity estimate, it should not
24 be given exclusive consideration. Mr. Cummings' dissertation on this issue, while
25 interesting from a theoretical viewpoint, does not support his rebuttal position that the
26 Commission would be better served or that the CAPM cost of equity would be more
27 accurate by relying on only part of the data available to investors. All of the available
28 data—both the geometric and arithmetic average market risk premiums—should be used in
29 calculating a CAPM cost of equity capital.
30

31 Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY IN THIS
32 PROCEEDING?

33 A. Yes, it does.

³ It is also noteworthy that the financial literature cited by Copeland, et al, (late 1980s) is substantially more recent than that of Blume (1974) on whose work Mr. Cummings relies most heavily.



BEFORE THE ARIZONA
CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF)
U S WEST COMMUNICATIONS, INC., A)
COLORADO CORPORATION, FOR A)
HEARING TO DETERMINE THE EARNINGS)
OF THE COMPANY, THE FAIR VALUE OF THE)
COMPANY FOR RATEMAKING PURPOSES,)
TO FIX A JUST AND REASONABLE RATE OF)
RETURN THEREON AND TO APPROVE RATE)
SCHEDULES DESIGNED TO DEVELOP SUCH)
RETURN)

DOCKET NO. T-1051B-99-105

SURREBUTTAL TESTIMONY OF
HARRY M. SHOOSHAN III
STRATEGIC POLICY RESEARCH,
INC.

September 8, 2000

SURREBUTTAL TESTIMONY OF
HARRY M. SHOOSHAN III

TABLE OF CONTENTS

1. INTRODUCTION	1
2. PRICING FLEXIBILITY.....	3
3. PRODUCTIVITY OFFSET	6
4. SERVICE QUALITY.....	10
5. INVESTMENT AND LITIGATION COMMITMENTS	12
6. TERM OF PLAN.....	12
7. THE QWEST PLAN	14
8. SUMMARY AND CONCLUSION	18

1 SURREBUTTAL TESTIMONY OF
2 HARRY M. SHOOSHAN III
3

4 1. INTRODUCTION

5 Q. ARE YOU THE SAME HARRY M. SHOOSHAN III WHO TESTIFIED
6 PREVIOUSLY IN THIS PROCEEDING?

7 A. Yes, I am.
8

9 Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

10 A. I am responding to the Rebuttal Testimony of Qwest Corporation witness Carl
11 Inouye and of Dr. William Taylor of n/e/r/a on behalf of Qwest Corporation.
12

13 Q. WHAT ISSUES RAISED BY MR. INOUE AND DR. TAYLOR WILL
14 YOU ADDRESS IN YOUR SURREBUTTAL TESTIMONY?

15 A. I will address Mr. Inouye's criticisms of the price regulation plan that I proposed on
16 behalf of Staff in my Testimony ("the Staff Plan"), specifically his contentions that:

- 17 ■ The Staff Plan does not provide Qwest with adequate flexiblity for
18 pricing existing services [Inouye at 2, 4-7];
- 19 ■ The Staff Plan actually removes existing pricing flexibility [Inouye at 2,
20 7];
- 21 ■ The Staff plan imposes rate reductions that would otherwise not occur
22 [Inouye at 2];
- 23 ■ The Staff Plan should not contain an offset related to service quality
24 [Inouye at 18];

- 1 ■ The Staff Plan should not anticipate additional investment
- 2 commitments by Qwest [Inouye at 19]; and
- 3 ■ The Staff Plan should not be conditioned on Qwest's commitments
- 4 regarding litigation [Inouye at 18].

5 I will address Dr. Taylor's criticisms of the Staff Plan, specifically his contentions
6 that:

- 7 ■ The Staff Plan makes a number of calculation errors in deriving the
- 8 appropriate productivity offset [Taylor at 3, 6, 10-13],
- 9 ■ The Staff Plan fails to provide Qwest with an adequate opportunity to
- 10 rebalance its rates and is inconsistent with recommendations I have
- 11 made elsewhere [Taylor at 6-9]; and
- 12 ■ The Staff Plan is not an appropriate tool for dealing with problems of
- 13 service quality (*i.e.*, that it is "too blunt an instrument") [Taylor at 13]
- 14 and that the approach taken will diminish the effects and incentives of
- 15 the Commission's service quality rules [Taylor at 14].

16 I will rebut Mr. Inouye's Testimony with respect to the alternative price regulation
17 plan he offers on behalf of Qwest ("The Qwest Plan") [Inouye at 8 *et seq.*].
18 Specifically, I will address his recommendations that:

- 19 ■ Switched access should be in the same basket as basic local exchange
- 20 service [Inouye at 8];
- 21 ■ Second lines should be included in Basket 3 [Inouye at 10];
- 22 ■ There should be no "hard cap" applied to any of the services in Basket
- 23 1 [Inouye at 11];
- 24 ■ The initial term of the price regulation plan should be three years with
- 25 Qwest having an option to renew for three additional years or return to
- 26 rate-base rate-of-return regulation [Inouye at 14]; and
- 27 ■ Competitive zones should be used to identify services that would be
- 28 moved to Basket 3 [Inouye at 12].

2. PRICING FLEXIBILITY

1
2 Q. BOTH MR. INOUE [AT 2, 4-7] AND DR. TAYLOR [AT 6-9] CRITICIZE
3 THE STAFF PLAN AS NOT PROVIDING QWEST WITH THE
4 FLEXIBILITY IT NEEDS AND, MORE SPECIFICALLY, THE
5 FLEXIBILITY TO REBALANCE RATES OR TO PRICE EXISTING
6 SERVICES. WOULD YOU COMMENT ON THEIR CRITICISMS OF
7 THE STAFF PLAN?

8 A. For services in Basket 3, the intent of the Staff Plan is to provide Qwest with the
9 same pricing flexibility as its competitors have today; that is, the flexibility to price
10 any retail service within a range bounded by a ceiling specified in a tariff and a floor
11 of total long-run incremental cost.¹ Mr. Inouye objects to the fact that some
12 services that are afforded flexible pricing today would not be placed in Basket 3 of
13 the Staff Plan [Inouye at 5]. I would point out that I have assigned existing services
14 to one of the three baskets proposed in the Staff Plan based discussions with the
15 Staff as to which services have presently been classified as competitive by the
16 Commission and, in any event, the breakdown in Attachment 1 to my Testimony is
17 meant to be illustrative, not dispositive.² My Testimony clearly stipulates that any
18 service that has been declared "competitive" or for which Qwest has received
19 flexible pricing authority to date should be placed in Basket 3 at the outset of the
20 price regulation plan. To the extent that my description of Basket 3 does not
21 include these services, I would propose to modify my proposal accordingly
22 [Shooshan at 11, 12, 13].

23 Mr. Inouye and Dr. Taylor are principally concerned about the fact that I have
24 proposed separate treatment for what I refer to as "wholesale services" and, in
25 particular, would not place carrier access in the same basket as basic local exchange

¹ Mr. Inouye suggests a different "price cap" arrangement for Basket 3 that I discuss subsequently. *See infra.* at 14.

² See note to Attachment 1 of my Testimony.

1 service [Inouye at 8, 10, 11; Taylor at 8, 9]. They further object to the Staff Plan's
2 requirement that intrastate access prices be reduced (to current interstate levels over
3 five years)³ without the opportunity to raise rates for basic local exchange service
4 (which is how they define "rebalancing") [Inouye at 6, 7, 11; Taylor at 8, 9].
5

6 Q. WOULD YOU ELABORATE ON YOUR DISAGREEMENT WITH MR.
7 INOUYE AND DR. TAYLOR ON THE ISSUE OF ACCESS CHARGE
8 REDUCTIONS AND REBALANCING?

9 A. Yes. Let me start with a point of agreement. I concur with Mr. Inouye and Dr.
10 Taylor that current pricing is not sustainable. As I wrote in a paper on the subject
11 of rate rebalancing:

12 In a market system, prices function as signals that guide production
13 and consumption decisions. If prices send faulty signals,
14 uneconomic consumption and investment decisions are the likely
15 consequences, with attendant sacrifices of economic welfare.⁴

16 In particular, one of the reasons we have not seen more competition develop for
17 basic local exchange service is that the prices for that service have been set low to
18 achieve public policy goals (*i.e.*, maintain affordable service and expand penetration).
19 It is also difficult to sustain the historical cost loadings on services that face
20 competition (*i.e.*, carrier access), especially since it is the "mispricing" of those
21 services that, in part, makes them especially attractive to competitors.

22 My disagreements with Mr. Inouye and Dr. Taylor are not so much with the
23 problem they posit, but with the solution they recommend—that is, that the costs in

³ Dr. Taylor's semantic quibble [Taylor at footnote 9] notwithstanding, he fundamentally disagrees with having the Commission fix reductions in the very access charges he says are inefficiently priced today. I am puzzled why Dr. Taylor, who is so concerned about achieving efficient pricing, would object to the Commission moving intrastate access prices in this direction (*i.e.*, to parity with interstate access charges).

⁴ John Haring and Harry M. Shooshan III, *Cutting the Gordian Knot of Rate Rebalancing*, prepared for the 29th Annual Conference of the Institute of Public Utilities, "Reconciling Competition and Regulation," Williamsburg, Virginia (December 5, 1997).

1 question must be recovered by increasing prices for basic local exchange service as
2 access prices are reduced. And, I emphasize that Qwest is asking the Commission
3 for approximately a \$45-million increase in basic service rates [Teitzel Supplemental
4 Testimony at 41] while proposing only minimal reductions in carrier access charge
5 [Shooshan at 3]. The Staff Plan offers a better alternative. Under the Staff Plan,
6 Qwest has the ability to rebalance by taking advantage of (1) retail pricing flexibility
7 for services in Basket 3 (including new services and service packages); and (2) the
8 same service packaging freedom as is afforded their competitors. Put another way,
9 the Staff Plan would permit Qwest to recover its costs by offering consumers
10 innovative new services and packages of services, rather than by simply raising basic
11 local exchange rates. In effect, the Staff Plan can be said to permit consumers to
12 select "rebalanced rates" from among a variety of value-added options rather than
13 to forcing consumers who only want—or who rely on—basic local exchange service
14 to pay more.

15 Contrary to Dr. Taylor's assertion [Taylor at 9], the Staff Plan *does* permit Qwest to
16 recover its fixed loop costs over a wider range of services and offerings—it just does
17 not permit Qwest to do so by raising the rates for basic local exchange service.
18 There are many "variations" of price cap plans and more than one approach to rate
19 rebalancing. The Staff Plan permits rebalancing to take place over time without
20 *forcing* consumers who only want "plain old telephone service" to pay more.

21

22 Q. DR. TAYLOR ASSERTS THAT, UNDER THE STAFF PLAN, NO RATES
23 IN BASKET 1 COULD BE INCREASED, SINCE ALL SERVICES ARE
24 SUBJECT TO WHAT YOU CALL A "HARD CAP," AND THAT THESE
25 RATES COULD ONLY GO DOWN OVER TIME AS THE PRICE CAP IS
26 APPLIED [TAYLOR AT 6, 7]. IS HE CORRECT?

27 A. No, Dr. Taylor is incorrect. Only "basic" services in Basket 1 are subject to the
28 "hard cap" [Shooshan at 13]. Thus, for example, the prices for flat rate residential
29 and flat rate business services that are in effect when the price regulation plan is
30 initiated could not be increased for five years. Prices for some services in Basket 1

1 (e.g., existing service packages) could be increased as long as the weighted average
2 price level of all services within the basket is less than or equal to the price cap
3 index. If an increase would cause the weighted average price level to exceed the
4 price cap index, then the prices of other services in the basket must be reduced.
5 Presumably, Dr. Taylor is familiar with these mechanics since they are typical of
6 most price regulation plans.

7
8 Q. DR. TAYLOR SUGGESTS THAT THE STRUCTURE OF THE STAFF
9 PLAN IS IN CONFLICT WITH PREVIOUS RECOMMENDATIONS
10 THAT YOU HAVE MADE ABOUT RATE REBALANCING [TAYLOR
11 AT 8]. WOULD YOU COMMENT?

12 A. I can say unequivocally that the Staff Plan is consistent with the view expressed in
13 the paper that Dr. Taylor cites.⁵ Moreover, the suggestion that a price cap plan
14 must permit basic local exchange rates to be increased as access charges are reduced
15 is an example of what the paper refers to as pointing the rebalancing "gun" at
16 regulators' heads. While reasonable people might disagree about how many degrees
17 of freedom to give Qwest under the circumstances, I believe it is unreasonable for
18 Dr. Taylor to suggest that the Staff Plan "rules out any kind of rate rebalancing as
19 part of its proposed reduction in carrier access charges" [Taylor at 8].
20

21 3. PRODUCTIVITY OFFSET

22 Q. DR. TAYLOR ASSERTS THAT YOU HAVE ERRED IN A NUMBER OF
23 RESPECTS IN CALCULATING THE PRODUCTIVITY OFFSET IN

⁵ Haring and Shooshan (1997).

1 THE STAFF PLAN. WOULD YOU PLEASE DESCRIBE DR. TAYLOR'S
2 ARGUMENTS?

3 A. Specifically, Dr. Taylor argues that I should have included data prior to Qwest's
4 most recent rate case in Arizona; that I did not employ the correct formula for
5 developing a productivity offset in a price cap plan; and that productivity should be
6 based on industry performance rather than individual company performance. Dr.
7 Taylor further criticizes the data upon which I relied. He suggests that the use of
8 the difference between rate-adjusted operating revenues and deflated expenses to
9 approximate growth in outputs and inputs is too imprecise. The implication here is
10 that a full-blown Total Factor Productivity ("TFP") study is required. Finally, Dr.
11 Taylor criticizes the reliance on intrastate data only [Taylor at 10-13].
12

13 Q. HOW DO YOU RESPOND TO DR. TAYLOR'S ASSERTIONS?

14 A. As a general matter, it is important to keep in mind that price cap plans, including
15 components such as productivity offsets, are developed through a variety of means
16 across jurisdictions. Further, price cap plans are often agreed to in settlement
17 proceedings between the carrier and the regulator. Therefore, there is no single
18 "right way to do things" and no hard-and-fast rules for the development of a
19 productivity offset in a price cap plan.

20 In response to Dr. Taylor's first point, regarding the appropriate time frame for data
21 to estimate Qwest's average annual productivity growth, we found it appropriate to
22 analyze data following Qwest's most recent rate case since changes in output,
23 approximated by changes in revenue, would be less subject to changes in price levels
24 and structures resulting from periodic rate cases. Further, the data prior to the 1993
25 rate case reflect a different industry structure where competitors were few and were
26 focused on limited service categories. With a new set of "rules" allowing unlimited
27 competitive entry and increased pricing flexibility, the most recent data (1995-1998)
28 upon which we rely are best able to predict the future growth in Qwest's output.

1 With regard to the "correct" formula for developing a productivity offset, there are
2 a number of alternatives now being used by the FCC and the various states. In fact,
3 some productivity offsets are set by statute without reference to a particular
4 formula. For example, the productivity offset in price cap plans for all incumbent
5 local exchange carriers ("ILECs") in Tennessee and Wisconsin is established in the
6 statute.⁶

7 With regard to whether an estimate of productivity growth in a price cap plan
8 should be industry-wide or company-specific, no single method is uniformly
9 adopted across the states. For the FCC price cap plan, an industry-wide estimate
10 makes sense, since the productivity offset is uniformly applied to all ILECs under
11 price cap regulation.⁷ The Tennessee productivity offset is also generally applicable
12 since it is embedded in a statute. In the Wisconsin statute regarding price cap
13 regulation, the initial productivity offset is greater for ILECs with over 500,000
14 access lines (*i.e.*, Ameritech Wisconsin, 3 percent) than for smaller ILECs in the state
15 (2 percent).⁸ Many states have initiated price cap regulation specifically for the
16 regional Bell Operating Company rather than for the industry statewide. For
17 example, in Illinois, the Commerce Commission considered Ameritech Illinois-
18 specific productivity data in the development of its price cap mechanism.⁹ Further,
19 as this Commission considers whether to remove Qwest from traditional rate of
20 return regulation, it is appropriate that the Commission choose a productivity
21 growth estimate that reflects Qwest's own costs and revenues, and the financial
22 impact on Qwest rather than relying on industry-wide data. At this time, neither the
23 Commission nor Qwest has enough information to gauge whether the use of
24 industry-wide data is relevant in Arizona.

⁶ Tennessee Code, Section 65-5-209(e); and Wisconsin Statutes, Telecommunications Utilities Price Regulation, Section 196.196.

⁷ In fact, the FCC industry-wide estimate has historically fell short in this respect, as it has not always included any mid-size ILECs that have elected price cap regulation.

⁸ Wisconsin Statutes. Telecommunications Utility Price Regulation, Section 196.196. 2(c).

⁹ Illinois Commerce Commission, *Order*, Docket Nos. 92-0448/93-0239 (October 11, 1994).

1 Further, we had considered whether to use "unseparated" data, as Dr. Taylor
2 recommends. We discovered, however, that the FCC and this Commission's
3 accounting rules were not consistent and determined that it would be most
4 appropriate to consider intrastate data only. Finally, if one were to use both
5 intrastate and interstate data, the estimated productivity growth for the company as
6 whole would be higher, since interstate productivity growth is generally higher than
7 intrastate productivity growth. Therefore, our estimate of Qwest's productivity
8 growth is conservative but appropriate, given that the price regulation plan I
9 propose covers only Qwest intrastate services.

10 The fact that we relied on revenues and costs, which Dr. Taylor believes are only
11 "rough" approximations of TFP [Taylor at 12], is not significant. To conduct a TFP
12 study is an expensive and complex endeavor that, in my view, is unnecessary in this
13 proceeding. Moreover, prior to the filing of Staff's direct case, Qwest was willing to
14 rely on its own estimate of productivity growth using the same data upon which we
15 relied. Qwest introduced these data in the record when it provided its own
16 productivity growth estimates in an attachment in its direct case in this proceeding
17 [Direct Testimony of George A. Redding, Exhibit GAR-12] and when it provided
18 Staff with the backup in response to Data Request No. SPR-03-001.¹⁰

19 Our methods and data were reasonably applied in this proceeding. As I have noted,
20 a variety of methods have been employed across the states. And, the results we
21 obtained are not inconsistent with those in other states [Shooshan at 14]. Thus, I
22 find that Dr. Taylor's arguments are not compelling and urge that they be
23 disregarded.
24

¹⁰ While Qwest has not offered an alternative measure of productivity in its rebuttal case, Dr. Taylor graphs on page 10 of his Testimony the same time series of Qwest's productivity growth from 1988-1998, using the very data he criticizes.

4. SERVICE QUALITY

1
2 Q. BOTH MR. INOUE AND DR. TAYLOR OBJECT TO THE STAFF
3 PLAN HAVING A COMPONENT TO DEAL WITH SERVICE QUALITY
4 AND SPECIFICALLY TO YOUR SUGGESTION THAT AN INITIAL
5 OFFSET MIGHT BE WARRANTED IN LIGHT OF EXISTING
6 PROBLEMS WITH SERVICE QUALITY [INOUE AT 18, 19; TAYLOR
7 AT 13, 14]. WOULD YOU RESPOND TO THEIR OBJECTIONS,
8 INCLUDING THE CONTENTION THAT SUCH AN OFFSET WOULD
9 UNDERMINE QWEST'S INCENTIVES TO MAKE THE
10 INVESTMENTS IT HAS ALREADY PROMISED THE COMMISSION
11 AS A CONDITION OF ITS RECENT MERGER WITH US WEST
12 [INOUE AT 18; TAYLOR AT 13]?

13 A. I disagree with their assertions. In order to provide effective safeguards for
14 consumers, regulators must control both price and quality. To control the former
15 without an effective means of controlling the latter does not constrain the regulated
16 firm from exercising market power. In effect, Dr. Taylor is acknowledging that
17 Qwest has market power and, if given the opportunity and the incentive, will
18 exercise it by degrading quality further or "disinvesting" [Taylor at 14, 16]. Further,
19 as Dr. Taylor presumably knows, one of the acknowledged weaknesses of price
20 regulation is that it can give the regulated firm an incentive to reduce service quality
21 in order to maximize profits.¹¹ In order to offset this incentive— or in response to
22 observed reductions in service quality under price regulation— regulatory bodies
23 have taken a variety of steps to remedy the problem, including the use of offsets. In
24 my Testimony, I propose a service quality offset to be used *only if* the company fails
25 to meet the mark set in its service quality tariff. This further penalty can be seen as

¹¹ Professor Sir Bryan Carsberg, "Lessons from the British Experience with Price Cap Regulation," *Telecommunications in a Competitive Environment, Proceedings of the Third Biennial Telecommunications Conference*, sponsored by n/e/r/a (April 12-15-1989).

1 a "sword of Damocles" to hold over the company's head to induce it to perform. If
2 the problem is intractable, and the "sword" has to be used, consumers will at least
3 be assured that the prices they pay will more closely match the quality of service
4 they are receiving. In the long run, of course, this suggests a downward spiral that I
5 hope can be avoided. A far better outcome is that a combination of Qwest's
6 commitments to the Commission in the context of its merger with US WEST,
7 competitive realities and the overall incentives created by the Staff Plan will correct
8 the problem without the need for a price cap offset (or additional fines and
9 penalties, for that matter). And, as to the concerns about imposing an initial offset
10 to deal with existing service quality problems, another option would be to delay the
11 start of a price regulation plan until Qwest has brought its service up to acceptable
12 levels.

13 Q. HAVE YOU RESEARCHED HOW OTHER STATES ADDRESSED
14 SERVICE QUALITY IN THE CONTEXT OF ALTERNATIVE
15 REGULATION?

16 A. Yes. I investigated the treatment of service quality in various states' price regulation
17 plans. In at least 13 states, additional service quality standards and/or penalties were
18 developed in conjunction with their alternative regulation plans.¹² Rhode Island,
19 Illinois, Wisconsin and Massachusetts, for example, have specifically included a
20 service quality index as an adjustment factor in their price cap formulas as contained
21 in the Staff Plan.⁶ It is perfectly appropriate for this Commission to consider
22 inclusion of a service quality offset, particularly given the recent problems with the
23 quality of Qwest's service in Arizona.

¹² Vivian Witkind Davis and Michael Clements, "Recent Developments in Telecommunications Service Quality Regulation," National Regulatory Research Institute (Spring 1998 Survey of State PUCs).

⁶ Other means of dealing with service quality under price caps are financial penalties levied against the firm and/or compensation paid directly to the aggrieved consumers. See Carsberg, at 201. I would note that both of these means have been employed in Arizona with the result that service quality has still declined in recent years.

5. INVESTMENT AND LITIGATION COMMITMENTS

1
2 Q. MR. INOUE OBJECTS TO THE SUGGESTION IN YOUR
3 TESTIMONY THAT QWEST MAKE CERTAIN INFRASTRUCTURE
4 COMMITMENTS OR CONCESSIONS CONCERNING LITIGATION AS
5 CONDITIONS OF ANY PRICE REGULATION PLAN [INOUE AT 19-
6 20]. HOW DO YOU RESPOND?

7 A. Mr. Inouye cites the investment commitments required by the Commission in
8 approving Qwest's merger with US WEST as all that is necessary [Inouye at 19]. I
9 point out in my Testimony that companies in other states have proposed such
10 commitments in conjunction with the transition to price regulation [Shooshan at
11 20]. The merger approval process in Arizona was a separate matter and presumably
12 the merger was evaluated by the Commission under different criteria than apply in
13 this case. As such, it would not be unreasonable for the Commission to expect
14 *additional infrastructure commitments* by Qwest (possibly increasing the pace and
15 reach of its DSL deployment, Shooshan at 19) as a condition of a price regulation
16 plan.

17 Mr. Inouye also objects to the recommendation in my Testimony that Qwest agree
18 to certain conditions respecting pending and future litigation [Shooshan at 17]. His
19 basis for objection is that the Staff Plan is not favorable enough to Qwest to warrant
20 these conditions [Inouye at 18]. Since I believe the Staff Plan does give Qwest the
21 requisite pricing flexibility—in addition to other advantages, I do not find his
22 objection compelling. I urge the Commission to adopt the conditions precisely as I
23 have recommended them.

6. TERM OF PLAN

24
25
26 Q. MR. INOUE SUGGESTS THAT THE INITIAL TERM OF A PRICE
27 REGULATION PLAN BE SET AT THREE YEARS, RATHER THAN

1 FIVE YEARS AS YOU SUGGEST [INOUE AT 14]. HE ALSO
2 PROPOSES THAT, AT THE END OF THREE YEARS, QWEST COULD
3 ELECT WHETHER TO EXTEND THE PLAN FOR ANOTHER
4 THREE YEARS OR REVERT TO RATE OF RETURN REGULATION
5 [INOUE AT 14]. IS THIS APPROACH DESIRABLE IN YOUR
6 OPINION? AND IF NOT, WHY NOT?

7 A. This is not a desirable approach. In the first place, the five-year term included in
8 The Staff Plan is preferable in order to maximize the incentive effects of price
9 regulation. The company seeks a shorter term because "it is impossible to predict
10 the outcome of the ratemaking portion of this docket" [Inouye at 14]. The
11 company wants to retain the option of reverting to rate of return regulation after
12 three years if things are not working out as anticipated.¹⁴ It seems to me that this
13 uncertainty will be removed when the Commission resolves the matters relating to
14 rates, which presumably it will do prior to the initiation of any price cap plan. At
15 that time, if the company has concerns, it can always elect to remain under rate-of-
16 return regulation. If the company nevertheless insists on a shorter term, I would
17 not strongly object, however. What is problematic is giving the company *alone* the
18 option to elect whether to extend the plan at the end of the initial term, whatever its
19 duration. The Staff Plan anticipates that the Commission— not the company— will
20 decide whether and for how long to extend the plan, once it has ascertained that the
21 plan is "actually providing the expected benefits to consumers" [Shooshan at 3].
22 Finally, I note that the Qwest Plan seeks to "eliminate the possibility of a rate case
23 in 6 years whereby any competitive losses would be passed back to basic customers
24 at that time" [Inouye at 15]. If protecting basic customers from bearing any
25 competitive losses is a concern (which it is), then the risk remains after three years
26 just as after six. One of the strengths of price regulation is that it breaks the formal
27 linkage between "regulatory" costs and prices, thereby removing the opportunity for

¹⁴ This is especially troubling in the context of the company's competitive zone proposal as I discuss subsequently in this Surrebuttal Testimony. See *infra* at 16.

1 a company to "game" the process by arbitrarily assigning costs to various services,
2 some of which will be more competitive than others. By adopting the Staff Plan,
3 the Commission can signal that it intends to break that linkage and rely on price
4 regulation— rather than the assignment of costs— to protect both consumers and
5 competitors against the risk of cross-subsidy.
6

7 7. THE QWEST PLAN

8 Q. MR. INOUE OFFERS A PRICE REGULATION PLAN ("THE QWEST
9 PLAN") AS AN ALTERNATIVE TO THE STAFF PLAN [INOUE AT
10 15]. WHAT IS YOUR OPINION OF THE QWEST PLAN?

11 A. On the one hand, I am pleased that Qwest has decided to put a price regulation plan
12 on the table, and I agree with Mr. Inouye that price regulation has a number of
13 benefits that recommend it over traditional rate of return regulation [Inouye at 3].
14 On the other hand, it is certainly not true that *any* price regulation plan would have
15 these benefits.

16 The devil, as always, is in the details, and the Qwest Plan is seriously deficient in a
17 number of respects. I divide my concerns into four areas: (1) the structure of the
18 plan; (2) the "population" of the baskets (that is, Qwest's decisions about where
19 existing services are assigned); (3) basket "governance" (that is, the price rules that
20 apply to Qwest's two baskets and to services within baskets); and (4) the linkage to
21 Qwest's "competitive zone" proposal.¹⁵ I now address each of these problem areas
22 in turn.

¹⁵ I have already addressed Dr. Taylor's criticisms of our efforts to arrive at an appropriate productivity offset for services in Basket 1 and have noted that he apparently rejects the use of the productivity data supplied by his own client. *See supra.* at 9. Perhaps it is for that reason that the Qwest Plan chooses not to specify a productivity offset at all.

1 Structure of the Qwest Plan. Qwest proposes two baskets, in effect, eliminating the
2 “wholesale” basket or Basket 2. I prefer the three baskets under the Staff Plan,
3 principally because that structure seeks to segregate “wholesale” from “retail”
4 prices.¹⁶ As competition intensifies, I expect that the attention of the Commission
5 will be increasingly focused on controlling the wholesale prices which govern
6 important inputs competitors need in order to compete with Qwest. My major
7 difference with Mr. Inouye’s proposal is that he would place carrier access charges
8 in Basket 1.

9 Population of the Baskets. As I have stated previously, I do not believe it is
10 necessary that carrier access and basic services be in the same basket. First, it is
11 important to keep wholesale prices separate from retail prices. Second, Qwest can
12 use other means of rebalancing rather than raising basic local exchange rates as it
13 seeks to do in this proceeding. While it is a closer call, I would also oppose
14 assigning residential and business lines beyond the primary line and PBX trunks
15 beyond the first trunk to Basket 3 at this time [Inouye at 9, Exhibit CTI-2 at 2]. I
16 recognize that these lines/trunks could be considered “nonessential” and also that at
17 least some consumers may have options for second lines (e.g., wireless phones, cable
18 telephony). However, this decision would be better made by the Commission in a
19 separate proceeding as envisioned by the Staff Plan [Shooshan at 11].¹⁷ Finally, Mr.
20 Inouye states that “Qwest has previously been granted pricing flexibility for special
21 access/private line” and that the company “has been granted ‘streamlined’ pricing
22 by the Commission for several existing ‘service packages’” and that these offerings
23 should be properly placed in Basket 3 [Inouye at 5]. My understanding is that
24 “intraLATA toll services” have been classified as competitive and that the

¹⁶ As I read Mr. Inouye’s Testimony, Qwest does not see the need for a separate wholesale basket because the only existing “service” that Qwest would not assign to one of its two baskets would be UNEs (and presumably local resale) which we agree is governed by a separate set of pricing rules. Thus, our disagreement about whether a third basket is needed can be seen as a disagreement about where services should be assigned. See Inouye at 10.

¹⁷ I would not object to Qwest’s view that the Commission should specify the elements of the “less rigorous test” envisioned in my Testimony as part of this price regulation plan [Inouye at 6]. I have indicated what such a test might be [Shooshan at 11].

1 Commission has defined those services as "interexchange Private Line (point-to-
2 point dedicated circuit) Service, and interexchange MTS, WATS, 800 service and
3 optional calling plans."¹⁸ Accordingly, "intraLATA toll services" (as defined) should
4 be placed in Basket 3. To the extent that Qwest has been accorded pricing
5 flexibility for certain existing "service packages," those packages should also be
6 placed in Basket 3. It is certainly the intent of the Staff Plan that Qwest not lose any
7 pricing flexibility that it already has been granted by the Commission as a result of
8 implementing the Staff Plan.

9 Basket Governance. The Qwest Plan proposes a revenue cap for Basket 1, thereby
10 rejecting the typical "inflation less productivity" form of price cap. This omission
11 might be explained, as I previously noted, by the fact that their consultant in this
12 case (Dr. Taylor) believes the productivity data Qwest has provided are
13 inappropriate for use by the Commission [Taylor at 12-13]. The lack of an
14 "inflation less productivity" *index mechanism denies Arizona consumers the direct*
15 *benefits of increased efficiencies Qwest can be expected to achieve under price*
16 *regulation.*

17 Mr. Inouye further opposes the use of a "hard cap" primarily because Qwest seeks
18 to rebalance rates by raising prices for basic services. I have already stated my
19 concerns about the Qwest approach, especially in light of the magnitude of increases
20 for basic services it has proposed in this case. I believe a "hard cap" is a legitimate
21 tool for protecting consumers who rely on basic services, particularly during the
22 initial price cap term.

23 On the other hand, Qwest should have the flexibility to adjust prices of services in
24 Basket 1 within the overall cap, and Mr. Inouye is correct in observing that the
25 "hard cap" as described in my Testimony [at 12], in conjunction with the price cap
26 formula proposed in the Staff Plan, will tightly constrain Qwest's ability in this
27 respect [Inouye at 6-7]. The Commission could certainly consider reducing the

¹⁸ ACC Decision 59637, April 25, 1996, Finding of Fact 7.

1 range of services subject to the "hard cap" and/or adjusting the price cap formula if
2 it wants to provide Qwest some additional flexibility within Basket 1.

3 For Basket 3, Qwest proposes to use a price cap based on the weighted average of
4 prices of the services in that basket plus 15 percent. Prices could be raised, and
5 terms and conditions of services changed with one-day's notice to the Commission.
6 Further, prices could be lowered with no notice to the Commission. This approach
7 has some advantages over the approach to Basket 3 pricing in the Staff Plan
8 [Shooshan at 12-13]. For consumers, it means that, should Qwest seek to raise
9 prices for some services in the Basket such that the adjusted weighted average price
10 cap would be exceeded, it must lower other prices. Under the Staff Plan, it is
11 possible that prices could only go up (unless "checked" by effective competition), as
12 long as they remain below the tariff ceiling set *for that service*. For the Commission,
13 the overall revenue cap proposed by Qwest could be easier to monitor and
14 administer than dozens of individual tariff-based caps. However, if the Commission
15 is to monitor such a cap, it must also have knowledge of price reductions. I
16 presume that Qwest intends to file a tariff or some form of notice on the effective
17 date of a price reduction to enable the Commission to track the effect on the cap.

18 The Competitive Zone Proposal. Mr. Inouye proposes the use of competitive
19 zones "with the basket approach" [Inouye at 12]. Specifically, Qwest proposes that
20 services within competitive zones (as defined by Commission rule) be moved to
21 Basket 3. While the use of competitive zones to move services to Basket 3 on a
22 geographic basis would be far less troubling to me in the context of true price
23 regulation than it is under the traditional rate-base rate of return regulation approach
24 initially favored by Qwest in this proceeding, Qwest's price regulation plan, as
25 presented, is really nothing more than a proposal to extend the "regulatory lag" for
26 three more years after which time *it* can decide whether to go back to traditional
27 rate-base rate of return regulation. Thus, my concerns about the use of competitive
28 zones are still as stated in my Testimony [at 3-4]. While Mr. Inouye is correct that
29 Oregon is using the competitive zone approach [Inouye at 13], it is currently doing
30 so within the context of a price regulation plan. Moreover, the Oregon legislature

1 has mandated that the Oregon Public Utility Commission no longer use rate of
2 return regulation once a company elects price regulation.¹⁹

3

4 Q. WHAT ARE YOUR VIEWS ABOUT THE COMPANY'S PROVISION
5 FOR TREATMENT OF "EXOGENOUS FACTORS"?

6 A. The Qwest Plan appropriately makes provision for adjustments to the price cap
7 formula due to exogenous factors. I am concerned, however, that the standard
8 Qwest would have the Commission apply is far too broad [Inouye Exhibits at 3].
9 The basis for adjusting the price cap formula to reflect exogenous changes should
10 be defined as narrowly as possible. An exogenous factor should be employed in the
11 instance of changes beyond Qwest's control that have a measurable effect on
12 Qwest's costs or revenues. Exogenous changes that are appropriate would include
13 tax law changes, accounting regulation changes and regulatory changes that cause
14 more than a *de minimis* change in Qwest's costs or revenues in Arizona.

15

16

8. SUMMARY AND CONCLUSION

17 Q. WILL YOU PLEASE SUMMARIZE YOUR SURREBUTTAL
18 TESTIMONY?

19 Yes. I respond both to criticisms of the Staff Plan proposed in my Testimony and
20 to the alternative plan proposed by Qwest as a substitute for the Staff Plan. With
21 regard to the Staff Plan, Qwest asserts that it does not afford adequate pricing
22 flexibility, particularly to enable rate rebalancing. As I have described, Qwest may
23 rebalance by a variety of means, including adjusting rates of non-basic services.

¹⁹ Oregon Revised Statutes, O.R.S. 759.410.

1 There is no compelling need to have wholesale and retail services in the same
2 basket. Further, while Qwest alleges that the Staff Plan reduces existing pricing
3 flexibility awarded to Qwest, it is the intent of the Staff Plan (as I have clarified) that
4 any services or packages receiving flexibility today should continue to have
5 flexibility. Contrary to Dr. Taylor and Mr. Inouye's objections, the inclusion of a
6 service quality offset is not unreasonable, as other states have similarly included such
7 an offset in their price cap plans. I do not agree with Qwest's positions of foregoing
8 additional infrastructure commitments and rejecting the conditions related to
9 litigation that I advanced in my Testimony.

10 I strongly disagree with Dr. Taylor's position that there is a "one size fits all"
11 approach to establishing price regulation. State price regulation plans and their
12 elements, including productivity offsets, have been arrived at through a variety of
13 methods and are not always based on the formula that Dr. Taylor prefers. It is
14 important, as the Commission moves away from rate-base rate of return regulation,
15 to consider Qwest's own data related to its operations in Arizona. It is appropriate
16 to use in this proceeding data subsequent to Qwest's last Arizona rate case since
17 those data are less subject to significant rate level and structure changes.
18 Additionally, the markets in which Qwest operates today— and will in the future—
19 are markedly different than they were 10 years ago. In criticizing the Staff's
20 productivity growth measure, Dr. Taylor rejects use of the very data and method
21 favored by his client, Qwest. The Commission should disregard these criticisms.

22 While Qwest has indicated its willingness to consider a price regulation plan as an
23 alternative to traditional rate-base rate of return regulation, the Qwest Plan is flawed.
24 Qwest— rather than the Commission— retains the option to re-instate rate of return
25 regulation after three years. As I have described, this would permit Qwest to seek
26 rate increases to cover competitive losses. For this same reason, I still reject
27 Qwest's competitive zone element of its plan. One element of Qwest's proposal
28 deserves consideration. The proposed revenue cap on all services in Basket 3 may
29 have advantages for both consumers and the Commission.

1 Of the two plans before the Commission, the Staff Plan is superior in terms of
2 providing the company with pricing flexibility, allowing for some rate rebalancing,
3 and providing greater consumer benefits.

4

5 Q. DOES THIS CONCLUDE YOUR TESTIMONY?

6 A. Yes, it does.